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The New-Millennium Dilemma: Does Reliance on the Use of Computer Servers and Websites in a Global Electronic Commerce Environment Necessitate a Revision to the Current Definition of a Permanent Establishment

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THE NEW-MILLENNIUM DILEMMA: DOES RELIANCE ON THE USE OF COMPUTER SERVERS AND WEBSITES IN A GLOBAL ELECTRONIC COMMERCE ENVIRONMENT NECESSITATE A REVISION TO THE CURRENT DEFINITION OF A PERMANENT ESTABLISHMENT?

*Randolph J. Buchanan**

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I. INTRODUCTION

THE role of technology has had a dramatic effect on the way in which businesses perform their daily activities. Many companies are moving away from the traditional ways of conducting business, such as communicating face-to-face or by mail order. Instead, these companies have chosen the Internet as their primary means of generating sales because it is more efficient and less costly. Because of the changes necessitated by the new global economy, the traditional customer base of a business has greatly expanded. It now includes organizations and individuals that are located around the world. Moreover, these technological innovations have simultaneously increased the amount of competition facing a business, thus resulting in the lowest price to the consumer. This new technology has also produced negative consequences, such as an increased burden on tax authorities to preserve and improve the current financial infrastructure to ensure that they are able to share in the increased revenues generated from electronic commerce transactions. Fur-

thermore, conducting business over the Internet has resulted in the elimination of natural boundaries, thus adding to the need for immediate tax reform.

The Organization for Economic Cooperation and Development ("OECD"), a Paris-based organization taking the lead on coordinating electronic commerce and taxation issues, estimates that the value of electronic commerce transactions may approach 330 billion in United States dollars by 2000-2001 and could equal one trillion as early as 2003.¹ Furthermore, the number of Internet users worldwide has grown from 40 million in 1996 to more than 100 million by the end of 1997, and it is estimated that the number of computers with Internet connections will rise to one billion in the next six years.² As a result of these estimates, the future role of traditional business transactions in an electronic commerce environment and its effects on the various tax authorities remain uncertain.

At the OECD Ministerial meeting in 1998, it was decided that electronic commerce was not so different from the traditional forms of business commerce as to justify the implementation of a new system of taxation.³ Moreover, the main goals of the tax system in the United States, such as the need to provide certainty and predictability and to prevent double taxation, must not be forgotten.⁴ Specifically, the United States Treasury Department's guiding principle of neutrality,⁵ which rejects the imposition of new⁶ or additional taxes on electronic commerce transactions, requires the U.S. tax system to treat similar income equally, regardless of whether it is earned through electronic means or through existing channels of commerce.⁷ Moreover, the concept of neutrality promotes a flexible approach that adapts and reinterprets existing principles initially developed in a physical world to an electronic, borderless world.⁸ Likewise, any guidance or framework put forth must also be flexible and general enough to accommodate and deal with any technological advances and new ways of doing business that are currently unforeseen.⁹

1. Jeffrey Owens, *Progress Report: Taxation and Electronic Commerce*, 39 EUR. TAX'N 422, 422 (1999).

2. Dow Famulak et al., *Taxation of Electronic Commerce: Asia-Pacific*, 20 TAX NOTES INT'L 877, 877 (2000) [hereinafter Asia-Pacific].

3. See Owens, *supra* note 1, at 422.

4. Michael P. Boyle et al., *The Emerging International Tax Environment for Electronic Commerce*, 28 TAX MGMT INT'L J. 357, 360 (1999).

5. See U.S. Treasury Dep't, *Selected Tax Policy Implications of Global Electronic Commerce*, available at <http://www.ustreas.gov> (Nov. 22, 1996); see also Stephen M. Feldhaus, *Taxing International E-Commerce*, N.Y.U. J. INT'L L. & POL. (Sept. 11, 2000).

6. See Internet Tax Freedom Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681-719 (1998) (prohibiting for a period of three years any new U.S. taxes on Internet access and multiple or discriminatory taxes on electronic-commerce); see also Feldhaus, *supra* note 5, n.9.

7. See Feldhaus, *supra* note 5, at 2.

8. See U.S. Treas. Dep't, *supra* note 5, at 3.

9. Pamela M. Jensen, *Proposed Guidance on Selected Issues in Cross-Border Electronic Commerce Transactions*, WORLDWIDE TAX DAILY, Sept. 26, 2001, at para. 6, LEXIS, 2001 WTD 187-15.

Although proponents of any change in a tax system generally embrace the general principles of neutrality, efficiency, fairness, certainty, simplicity, and flexibility in the abstract, the specific approach to achieving these principles has proven much more troublesome.¹⁰

But the most critical issue currently affecting electronic commerce, and the one that continues to be vigorously debated among the OECD member countries, is whether there is a need to modify the existing definition of a permanent establishment ("PE") to conform to these recent technological advances, which now make it possible to operate a business globally over the Internet with only a computer server and a website. In addition, this issue has been increasingly scrutinized because of the numerous bilateral tax treaties currently in existence, almost all of which have provisions that deal with a PE. Because of this unresolved debate, the economic implications from electronic commerce transactions are generating significant concern among tax authorities due to the potential negative impact on international tax bases that could result in an enormous loss of tax revenue, if the OECD determines that a computer server is a PE for tax purposes.¹¹

This article will focus on the tax implications of concluding that a computer server and/or website is a PE. To clarify the main issues surrounding this ongoing debate, there will be a discussion of the consequences that a business entity engaged in electronic commerce transactions would likely face if the use of a computer server is declared to be a PE and what the business entity's likely responses would be if presented with such a scenario.

Parts II and III of this article will lay the foundation for the two most common situations that cause international businesses with global operations to suffer adverse tax consequences: 1) having the business enterprise engaged in a U.S. trade or business, thus leading to the result that their profits were "effectively connected" with that trade or business; or 2) a determination that the enterprise's business constitutes a PE for tax treaty purposes. In addition, Part III will begin with an examination of the historical factors that led to the creation of the current PE requirement.

Part IV will illustrate the interrelationship between Articles V and VII, which supports the basic framework of most bilateral tax treaties and is generating most of the current controversy over whether the PE requirement needs to be modernized. Included within this discussion will be an analysis of the characteristics of a PE and a determination of the importance of accurately calculating business profits, both in the context of the OECD model treaty. Moreover, there will be a discussion regarding the concept of agency as part of the PE threshold, as well as a brief introduction of the role a tax treaty plays in light of these characteristics.

10. Richard L. Doernberg, *Electronic Commerce: Changing Income Tax Treaty Principles a Bit?*, 21 TAX NOTES INT'L 2417, 2422-23 (Nov. 20, 2000).

11. See Boyle et al., *supra* note 4, at 358.

Part V will look at the roles computer servers and websites play in the modern business environment, with an emphasis on the consequences of concluding that a computer server is a PE. These consequences will be further analyzed in the context of the recent consensus put forth by the OECD and the likely effects and responses of these consequences on a business entity engaged in electronic commerce transactions. Furthermore, this part of the article will look at how legislatures and courts of other notable foreign countries have dealt with this issue, as well as some of the other significant issues that must be addressed when using a computer server and website together in global business operations. Finally, Part VI will provide an opinion as to the likely result from this controversy and whether or not the PE requirement will undergo any substantial changes in the near future.

II. THE INITIAL TAX TRAP FOR THE UNWARY: A DETERMINATION BY THE TAX AUTHORITIES THAT THE FOREIGN ENTERPRISE IS ENGAGED IN A U.S. TRADE OR BUSINESS

There are two primary tests that are used by the U.S. tax authorities in determining whether the use of a computer server through a website triggers the imposition of a tax. First, does the company generate income that is “effectively connected” with a U.S. trade or business; and second, does the company’s operations constitute a PE within the United States. Since both tests are independent from one another, either one will result in the imposition of a tax. However, the PE test requires the existence of a tax treaty; the “effectively connected” test does not. Therefore, the tax authorities generally begin their analysis with the “effectively connected” test since there is no formal requirement for the existence of a tax treaty with the United States. Moreover, a tax treaty is only relevant if the taxpayer is a resident of the country that has a tax treaty with the other country. For example, a French taxpayer doing business in the United States will not be taxed in the United States if the French taxpayer is a resident of France and the taxpayer does not have a PE in the United States pursuant to the U.S.-France income tax treaty. Thus, a foreign enterprise, without treaty protection, is subject to U.S. tax on the income effectively connected with a U.S. trade or business.¹²

Furthermore, the “effectively connected” test has a lower threshold than the PE test because there is no requirement that the U.S. trade or business have a fixed place of business. Consequently, if at the end of the analysis it is determined that a foreign company is engaged in a U.S. trade or business¹³ and has income that is “effectively connected” with that

12. See Jensen, *supra* note 9, at para. 8.

13. This determination involves a difficult factual analysis and is therefore a situation in which the IRS does not issue advance rulings. See Rev. Proc. 2001-7, 2001-1 I.R.B. 236. Although there is considerable authority for making this determination, it is primarily from the 1950’s or earlier. See, e.g., *Higgins v. Comm’r*, 312 U.S. 212 (1941); *Cont’l Trading, Inc.*

business, it is only necessary to determine whether the foreign company also has a PE in the United States if a tax treaty exists between the country of residence of the foreign company and the United States.

In general, a low level of activity is all that is required for the courts to conclude that the activities of a foreign corporation located outside of the United States is engaged in a U.S. trade or business. Consequently, all activities that are considerable, continuous, and regular will be treated as "effectively connected" with a U.S. trade or business.¹⁴ Continuous is defined as a day-to-day activity, rather than a sporadic activity.¹⁵ Moreover, to pass this test, an activity must occur regularly rather than irregularly, and it must be considerable as opposed to minimal.¹⁶ Thus, a non-resident alien individual whose only activity in the United States during the taxable year was the supervision and negotiation of leases covering rental property that he owned was held not to be engaged in a U.S. trade or business nor did he have income that was "effectively connected" to a U.S. trade or business.¹⁷ In contrast, a court might conclude that a foreign corporation that advertises to and deals with U.S. customers is engaged in a U.S. trade or business, if it retains persons or facilities located in the United States.¹⁸

Consequently, the determination of whether income from a foreign corporation is "effectively connected" to a U.S. trade or business is generally based on the facts and circumstances of each case. Thus, it is essential to make this initial determination in order to properly advise electronic commerce clients of tax planning opportunities, which are currently available. Furthermore, income that is "effectively connected" to a U.S. trade or business is taxed on a net basis at a graduated tax rate based on the level of taxable income of the foreign corporation.¹⁹ However, U.S. source income that is not "effectively connected" to a U.S. trade or business is generally taxed at a flat withholding tax rate of 30%.²⁰

v. Comm'r, 265 F.2d 40, 41 (9th Cir.), *cert. denied*, 361 U.S. 827 (1959); *Herbert v. Comm'r*, 30 T.C. 26, 26-27, *acq.*, 1958-2 C.B. 6 (1958).

14. Rev. Rule 73-522, 1973-2 C.B. 226; *see also* *Moore v. Comm'r*, 56 T.C.M. (CCH) 1150, 1155 (1989).

15. Rev. Rul. 73-522, 1973-2 C.B. 226.

16. *Id.*

17. *Id.*; *see also* *Neili v. Comm'r*, 46 B.T.A. 197 (1942) (holding that the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in [a] trade or business); *but cf.* *Schwarcz v. Comm'r*, 24 T.C. 733 (1955), *acq.* 1956-1, C.B. 8 (holding that the operation of one parcel of rental property in all of its aspects was considered to be engaging in a trade or business).

18. David R. Tillinghast, *Taxation of Electronic Commerce: Federal Income Tax Issues in Establishment of a Software Operation in a Tax Haven*, 4 FLA. TAX REV. 339, 345 (1999). *But see* *Piedras Negras Broad. Co. v. Comm'r*, 43 B.T.A. 297 (1941), *nonacq.*, 1941-1 C.B. 18, *aff'd*, 127 F.2d 260 (5th Cir. 1942) (finding that Mexican company which broadcast radio programs from Mexico into the United States and collected advertising revenues from U.S. companies was not engaged in a U.S. trade or business).

19. *See* I.R.C. § 871(b)(1) (1994 & Supp. V 1999). The current tax rates for U.S. corporations with taxable income of at least \$50,000 begins at 15% and progressively increases to 34% for corporations with taxable income of \$10,000,000 or less. *See* I.R.C. § 11(b)(1) (1994).

20. *See* I.R.C. § 871(a)(1)(A) (1994).

III. THE SECOND TAX TRAP FOR THE UNWARY: A DETERMINATION BY THE TAX AUTHORITIES THAT THE FOREIGN ENTERPRISE HAS A PERMANENT ESTABLISHMENT

If a tax treaty exists between the country of residence of the foreign enterprise and the United States, the tax authorities will apply the PE test in an attempt to impose a tax on the foreign enterprise. This involves answering two questions. First, does the foreign enterprise have a PE in the United States or elsewhere that would subject them to the imposition of an income tax? Second, assuming that it does have a PE, what amount of its business profits are taxable and at what rate under the applicable tax treaty with that particular contracting state?²¹ Since having a PE necessitates the existence of a tax treaty, once the elements of a PE have been met under Article V of the tax treaty, the calculation of business profits under Article VII becomes crucial.

The purpose of the PE requirement was to determine a particular point in time when a foreign entity providing goods or services had established a sufficient taxable presence or connection with a jurisdiction to entitle that jurisdiction to tax the transaction, including the business profits generated from it.²² Thus, it was essential to determine whether the enterprise had a PE in a particular contracting state since the business profits of the enterprise, operating in a contracting state that was different from the source state, could not be taxed by the source state unless their business activities were attributable to a PE.²³ But in order to appreciate the significance of the modern version of the PE requirement, an examination of the historical factors that led to the creation of this requirement must first be considered.

The development of a PE requirement became necessary at the beginning of the twentieth century to supplement the existing international law framework by providing a solution to the problem of double taxation, which the current international law, and the few premature bilateral trade agreements with tax provisions in existence at that time, had failed to address.²⁴ The problem of double taxation occurs “[w]hen income is earned in one country by a citizen or resident of another country, [and] both the country where income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income.”²⁵ Moreover, the basic premise behind international tax rules is “to resolve the competing claims of resi-

21. The use of language such as “other contracting state” in model tax treaties is a tax treaty term of art that refers to a particular country.

22. See Boyle et al., *supra* note 4, at 369.

23. PETER H. BLESSING, *INCOME TAX TREATIES OF THE UNITED STATES* ¶ 3.01[1], at 3-2 (1996).

24. ARVID A. SKAAR, *PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE* § 6.3, at 68 (1991).

25. Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1033 (1997).

dence and source nations in order to avoid the double taxation that results when both fully exercise their taxing power."²⁶ As a result, in 1928, the League of Nations issued a draft of a model tax treaty that relieves double taxation. It still serves as the basis for the model income tax treaties of the OECD, the United Nations, and the United States.²⁷

Furthermore, a PE requirement became imperative after the second industrial revolution because many new industries and transportation methods materialized, creating emerging issues that had never been encountered before, such as the mobility of labor forces and fixed capital as the primary characteristics of a business enterprise.²⁸ Many countries also expanded their activities across international borders, resulting in a tax liability to them in both their state of residence as well as the other contracting state, where they carried on a trade or business.²⁹ Moreover, the development of the PE requirement was based on the assumption that factors of production, labor, and capital assets were mobile within countries but immobile between them.³⁰ In addition, for purposes of international trade, movable business equipment was only important if it had a fixed location.³¹ Thus, unlike the modern business environment where labor and equipment are easily transported to a host country for the duration of a work assignment and then relocated without difficulty when the assignment is completed, the business environment that existed at the beginning of the twentieth century mandated a PE.³²

The history and evolution of the PE requirement can be broken down into four distinct periods in time: 1) the emergence of the PE concept in the Prussian-led empire from 1845 through 1909; 2) the adoption of the PE requirement in international treaties from 1899 through the end of World War I; 3) the re-evaluation of the principle of source-state taxation during the 1920's through the end of World War II; and 4) the consolidation and re-evaluation of the principle of residence-state taxation from the 1950's to the present.³³

A. THE EMERGENCE OF THE PERMANENT ESTABLISHMENT REQUIREMENT DURING THE PRUSSIAN EMPIRE

Initially, the concept of a PE began in Prussia during the second-half of the nineteenth century and it was used as a business term meaning "the total space used for the conduct of a business activity," rather than its

26. *Id.*

27. *Id.* at 1023. In addition, the fundamental structure of the 1928 League of Nations model tax treaty serves as the basis for more than twelve hundred bilateral tax treaties currently in force throughout the world. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEXAS L. REV. 1301, 1303 (1996).

28. See SKAAR, *supra* note 24, § 6.1, at 65, § 6.4, at 69.

29. *Id.* § 7.1, at 71.

30. *Id.* § 6.1, at 66.

31. *Id.*

32. See *id.* § 6.1, at 67.

33. See generally SKAAR, *supra* note 24, ch. 7, at 72-98.

modern terminology as a tax concept.³⁴ But PE as a tax concept emerged as a possible solution to the increased problem of double taxation that grew among the Prussian municipalities.³⁵ Based on the limited evidence existing from this era, it appears that the PE definition at this point in history "required permanence and location within an area . . . rather than physical location in one specific place."³⁶ Therefore, the Prussian rules were viewed as a limitation on source-state taxation that created certain conditions, such as the existence of a fixed physical location in the other contracting state, which subsequently became the core elements upon which the PE concept is currently based.³⁷ In addition, it had to be possible to recognize the enterprise's intention to continue performing the business activity at this location.³⁸ Thus, satisfying these two criteria gave the enterprise an objective presence, which was a necessary condition for taxability.³⁹ Furthermore, it was not until 1891 that the PE concept was codified in Prussia; it did not become law in Germany until the passage of the German Double Taxation Act of 1909, which eliminated double taxation among the German states.⁴⁰

B. THE ROAD TOWARD A FULL-SCALE ADOPTION OF THE PERMANENT ESTABLISHMENT REQUIREMENT

The basic rule governing a PE became a fixture in international treaties between 1899 and the end of World War I as a solution to the problem of double taxation. In order to facilitate cross-border trade, Austria-Hungary and Prussia entered into a treaty in 1899 that is recognized as the first international tax treaty.⁴¹ The development of this tax treaty was important because it contained several provisions that provided most of the framework for the modern PE requirement. First, business profits that were earned through a PE in the other country were to be taxed in that jurisdiction.⁴² Second, there must be a fixed place of business.⁴³ However, the language used in this treaty supported a broad definition of a PE and resulted in "all fixed places of business [being] a PE if they serve a business activity of a foreign enterprise, his partner or an agent."⁴⁴ Consequently, a place maintained for the sole purpose of purchasing goods or inventory constituted a PE, although the current OECD model treaty has listed this activity as a separate exclusion from

34. *See id.* § 7.2, at 72, 74 (concluding that the concept of a PE was not used in tax statutes until 1885).

35. *Id.* § 7.2, at 72.

36. *See id.* at 73.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 74. Moreover, since 1909, the basic definition of a PE in Germany has generally remained unchanged until it was revised in 1977. *Id.*

41. *Id.* § 7.3, at 75.

42. *Id.*

43. *Id.*

44. *Id.*

the basic definition of a PE.⁴⁵ Although the principle of a PE was a compromise between source-state and residence-state taxation, the treaty between Austria-Hungary and Prussia favored source-state taxation.⁴⁶ Thus, with the development of the first international treaty, the inclusion of a PE definition in a tax treaty became a common practice until the beginning of World War I; however, the problem of double taxation remained.⁴⁷

C. THE RE-EVALUATION OF THE PRINCIPLE OF SOURCE-STATE TAXATION

To help alleviate the burden of double taxation, the League of Nations assembled a group of economic experts led by Georg von Schanz and Edwin R.A. Seligman, who strongly influenced contemporary international taxation principles and future PE doctrine.⁴⁸ Their viewpoint was that the state in which the income had its "origin" would represent the state to which the income had the strongest economic allegiance, and hence where it should be taxed.⁴⁹ The income was to be taxed only once and allocated among the states based on their relative interests.⁵⁰ Moreover, these economists, as well as the International Chamber of Commerce, advocated full residence-state taxation as the best means to avoid double taxation.⁵¹ Under a residence-based system, "all income, wherever earned, would be defined and taxed according to the laws of the taxpayer's own country of residence."⁵²

In contrast, Thomas Sewall Adams, regarded by some scholars as the founder of the U.S. system of international taxation, also influenced international taxation principles by endorsing a system of source-based taxation that was based on "both principle and administrative convenience."⁵³ Under a source-based system, a taxpayer is obligated to pay tax according to the laws of the country in which his income is earned, regardless of his residence.⁵⁴ Moreover, Adams never fully rejected the principle of residence-based taxation; rather, he viewed residence-based taxation as a backstop to source-based taxation.⁵⁵

Because of its scholarly influence and the threat encountered by jurisdictional expansion over business income, the League of Nations made an

45. See OECD COMMITTEE ON FISCAL AFFAIRS, art. 5, para. 4(d), at 27 (1998).

46. See SKAAR, *supra* note 24, at 76.

47. *Id.*

48. *Id.* § 7.4.2, at 79-80.

49. *Id.* at 79.

50. *Id.* at 79-80.

51. *Id.* at 80-81.

52. Graetz & O'Hear, *supra* note 25, at 1034.

53. *Id.* at 1027, 1036; see also Graetz & O'Hear, *supra* note 25, at 1023 (citing International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 3 (Nov. 24, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923-1924 folder)).

54. See Graetz & O'Hear, *supra* note 25, at 1034.

55. *Id.* at 1038.

initial attempt at defining the concept of a PE in the 1920's, in order to ensure that "the only nation in which the PE of the business enterprise was located could legitimately levy source-based taxes on the enterprise's income."⁵⁶ They agreed that income from commercial activities was subject to source-state taxation if the enterprise had "a branch, an agency, [or] an establishment" situated in that state.⁵⁷ Furthermore, the 1927 draft convention on double taxation by the League of Nations allocated the amount of taxation derived from business profits to the source state if the enterprise had a PE, which was then defined as:

The real centres of management, branches, mining and oilfields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona fide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.⁵⁸

However, unlike the 1899 treaty between Prussia and Austria-Hungary and the German 1909-legislation, the definition contained in this version of the draft had little influence on bilateral tax treaties since it did not provide the basic rule of a PE.⁵⁹ Consequently, because of the problems encountered by the various contracting states regarding the bilateral conventions contained in the numerous drafts, the League of Nations finally concluded that "uniform law" was the best method for preventing international double taxation.⁶⁰

But unlike the 1933 League of Nations draft, which only contained *examples* illustrating what constituted a fixed place of business, the commentaries of both the Mexico and London model treaties of the 1940's contained the basic definition of a PE that an enterprise had to have a fixed place of business and this place must contribute to the profits of the enterprise.⁶¹ Moreover, the "productivity tests" contained within these model treaties functioned similarly to the "exclusion list" that is popular among the current OECD model treaties.⁶²

56. *Id.* at 1088.

57. *See* SKAAR, *supra* note 24, at 82.

58. JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION, 195 (1932) (quoting Draft Convention No. I-a, art. 5, *reprinted in* Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.562 M.178 1928 II, at 7-9 (1928)).

59. *See* SKAAR, *supra* note 24, at 83. The Hungary-Poland treaty of 1928 defines a PE as a business undertaking that is wholly or partly carried on. *Id.* at 83.

60. *See id.* at 85-86.

61. *See id.* at 92.

62. *See id.* at 93, 96.

D. THE RE-EVALUATION OF THE PRINCIPLE OF
RESIDENCE-STATE TAXATION

Beginning with the period immediately after the end of World War II, the conflict between residence-state and source-state taxation intensified by focusing on taxing jurisdictions rather than certain classes of income.⁶³ This gave additional incentive to the OECD to develop technical tax treaty provisions that would eliminate the threat of double taxation.⁶⁴ As a result, a movement to drop the principle of residence-state taxation in favor of source-state taxation gained momentum, especially during the 1960s.⁶⁵ The primary reason for the change was that "residence-state taxation disturbed the flow of capital between states, by discouraging new capital from being invested abroad. . . ."⁶⁶ The solution was the development of the 1963 OECD model treaty, which was similar to the drafts originally developed by the League of Nations.⁶⁷ It contained the current definition of a PE, retained the list of "positive" examples which always constitute a PE, and it replaced the "productivity test" under the Mexico and London model treaties with a list of exclusions that would never constitute a PE.⁶⁸ Furthermore, it was decided that the country of origin where the income was derived, had the sole right to tax the income.⁶⁹

However, the current economic climate, which favors the Internet as the preferred method of conducting business transactions, has appeared to shift the emphasis back to a residence-based system of taxation. For example, the United States has identified as a long-run objective the implementation of a residence-based system of taxation.⁷⁰ In 1996, the Treasury Department reiterated [this] preference for residence-based taxation by stating:

The United States, as do most countries, asserts jurisdiction to tax based on principles of both source and residence. If double taxation is to be avoided, however, one principle must yield to the other. Therefore, through tax treaties, countries tend to restrict their source-based taxing rights with respect to foreign taxpayers in order to exercise more fully their residence based taxing rights. . . . In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographic location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident[s] somewhere. An individual is almost always a citizen or a resident of a given country, and, at least under U.S. law, all corporations must be established under the

63. *Id.* at 82.

64. *Id.* at 96.

65. *Id.*

66. *Id.* at 98 (internal quotation omitted).

67. *Id.* at 96.

68. *Id.*

69. *See id.* at 97.

70. Graetz & O'Hear, *supra* note 25, at 1034.

laws of a given jurisdiction.⁷¹

In conclusion, the history of tax treaties since 1899 shows a continual shift from source-state taxation to residence-state taxation.⁷² Although the scope of the PE requirement has been narrowed down in recent years, resulting in a loss of tax revenue, the basic framework still remains.⁷³ In addition, both the League of Nations and the OECD have over time made significant progress in addressing the problem of double taxation, specifically with the development of a model tax treaty.⁷⁴ With regard to the PE requirement, the most important model conventions are the League of Nations drafts from 1927, 1933, and 1943, and the OECD model treaty from 1963, which was first revised in 1977 and again in 1992.⁷⁵

Although international law has yet to find an adequate answer to the problem of double taxation, the extensive network of bilateral tax treaties in place has significantly improved the legal framework facing business enterprises engaged in international business transactions.⁷⁶ A global economy relies on technology, such as the use of a website or computer server for business purposes, and, where the natural boundaries of other nations have been effectively eliminated by the use of such technology, has emerged as the catalyst for the re-examination of the usefulness of the current PE definition.

IV. THE INTERRELATIONSHIP BETWEEN ARTICLES V AND VII OF THE MODERN TAX TREATY

Articles V and VII of most bilateral tax treaties deal with the concepts and rules related to a PE and business profits, respectively. These articles are complementary to one another and thus must be considered together when advising electronic commerce clients about potential tax consequences associated with a particular transaction. However, the recent evolution of computer technology has resulted in a debate concerning the merits surrounding the general framework of the current PE requirement.

A. THE CURRENT PERMANENT ESTABLISHMENT REQUIREMENT UNDER THE OECD MODEL TAX CONVENTION: ARTICLE 5

Under the revised OECD Model Tax Convention,⁷⁷ a PE is defined as

71. U.S. Treasury Dep't, *supra* note 5, at 7.1.5.

72. Skaar, *supra* note 24, at 101.

73. *See id.*

74. *See id.* at 69.

75. *Id.* at 71.

76. *Id.* at 69.

77. The OECD Model Tax Convention, first published in 1963 and regularly updated since then, is the basic reference manual used by the OECD and non-OECD countries for the negotiation, application, and interpretation of bilateral tax treaties coordinating their tax systems. OECD, *OECD Countries Agree on Foreign E-Commerce Profit Taxes Interpretation*, WORLDWIDE TAX DAILY, Jan. 10, 2001, available at LEXIS, 2001 WTD 7-18.

a "fixed place of business through which the business of an enterprise is wholly or partly carried on."⁷⁸ The Commentary to Article Five elaborates on this definition by stating the essential characteristics of a PE, which are: 1) the existence of a "place of business"; 2) fixed in a specific location with a certain degree of permanence; and 3) the trade or business of the enterprise is carried on through this fixed place of business.⁷⁹ However, missing from the OECD definition is the requirement that the PE must contribute to the profits earned by the enterprise, which was present in both the Mexico and London model treaties of the 1940's.⁸⁰

The existence of a place of business is met if "any premises, facilities or installations of the entity were used to carry on the business of the enterprise, whether or not they were used exclusively for that purpose."⁸¹ Furthermore, "a place of business may also exist where no premises are available or required for carrying on the business," but the enterprise must have a certain amount of space at its disposal.⁸² Finally, it is irrelevant whether the facilities available for use by the enterprise are owned or rented.⁸³

To satisfy the requirement that a place of business be "fixed", there must be a link between the place of business and a specific geographical point,⁸⁴ and it must not be temporary in nature or set up for a temporary purpose.⁸⁵ This "temporal requirement relates to the taxpayer's use of a place of business;" hence, it is not sufficient for purposes of this requirement if the facility itself is permanent.⁸⁶ In other words, the place of business must be established at a *distinct* place and with a certain degree of permanence.⁸⁷ Moreover, the equipment or premises that give rise to a fixed place of business does not have to be attached to the soil for this requirement to be met; it only has to remain on the particular site.⁸⁸ Thus, an enterprise that only exists for a short period of time can still constitute a PE as long as its use was designed for more than a temporary

78. Article 5, *supra* note 45, at 26. The U.S. Treasury Department has adopted verbatim the language used in the OECD definition of a PE for its U.S. model income tax treaty, which was adopted September 20, 1996. See generally U.S. Dep't of Treas., *United States Model Income Tax Convention of September 20, 1996: Convention between the United States of America and for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, available at <http://www.treas.gov/taxpolicy/t0txmod1.html> (Sept 20, 1996) [hereinafter U.S. Model Income Tax Treaty]; Richard L. Doernberg & Kees Van Raad, *The 1996 United States Model Income Tax Convention: Analysis, Commentary and Comparison* 45 (1997).

79. OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, art. 5, para. 1, cmt. 2, at 70 (June 1998 condensed version) [hereinafter OECD Commentary to Article 5].

80. See *id.*, para. 1, cmt. 3; see also SKAAR, *supra* note 24, at 92.

81. OECD Commentary to Article 5, *supra* note 79, para. 1, cmt. 4, at 70-71.

82. *Id.*

83. *Id.*

84. *Id.*, para. 1, cmt. 5, at 71.

85. *Id.*, para. 1, cmt. 6, at 71.

86. BLESSING, *supra* note 23, ¶ 3.02[1][b][ii], at 3-20 (emphasis added).

87. *Id.* at 3-9; see also OECD Commentary to Article 5, *supra* note 79, para. 1, cmt. 2, at 70.

88. OECD Commentary to Article 5, *supra* note 79, para. 1, cmt. 5, at 71.

purpose.⁸⁹ Likewise, a place of business that was initially planned to be maintained only for a temporary period of time but is subsequently used on a non-temporary basis would be re-classified as a fixed place of business and hence a PE.⁹⁰ Finally, interruptions in the operations of the business do not change the permanent nature of an activity undertaken as long as the operations are carried out on a regular basis.⁹¹

In conclusion, the primary elements of the modern PE rule retain the original framework of the rule: the existence of a fixed, “permanent” place of business. But the modern rule has undergone some changes. The “permanence test” has been modified and now pertains to the business activity rather than the place where the business was located or the use of such a place.⁹² Moreover, the current version of the PE rule requires that a trade or business be carried on from the fixed place of business; the original definition from 1909 “depended on whether or not the place served the performance of a business activity.”⁹³ Thus, under the current PE definition, an example of a fixed place of business would be the premises of a facility such as a factory building.⁹⁴

Assuming that an enterprise has a fixed place of business, a PE “begin[s] to exist as soon as the enterprise commences to carry on its business through [that] fixed place of business.”⁹⁵ Carrying out the business operations of an enterprise is usually accomplished by employing agents who are generally dependent in nature.⁹⁶ Moreover, these dependent agents conduct the business of the enterprise in the other contracting state where the fixed place of business is located.⁹⁷ Article 5, paragraph two of the OECD model treaty lists a branch, office or a factory building as *prima facie* examples of places that automatically qualify as a PE.⁹⁸ Thus, a business enterprise has a PE once all three elements have been satisfied. However, under the modern tax treaties, ascertaining the status of an agent is not only a difficult task but also crucial to determining whether a PE exists.

89. *Id.*, para. 1, cmt. 6.

90. *Id.*

91. *Id.*, para. 1, cmt. 7.

92. *See* Skaar, *supra* note 24, at 74.

93. *Id.*

94. Article 5, *supra* note 45, para. 2(d), at 27.

95. Blessing, *supra* note 23, ¶ 3.02[1][b][iii], at 3-22.

96. *Id.* ¶ 3.02[1][b], at 3-9; *see generally* OECD Commentary to Article 5, *supra* note 79, para. 5, cmts. 31-35, at 79-80 (discussing activities and characteristics of agents that would lead to a place of business being classified as a PE). Blessing, *supra* note 23, ¶ 3.02[1][b], at 3-9.

97. Blessing, *supra* note 23, ¶ 3.02[1][b], at 3-9.

98. Article 5, *supra* note 45, para. 2, at 27. The 1996 U.S. model income tax treaty also lists these same examples as constituting a PE. *See generally* U.S. Model Income Tax Treaty, *supra* note 78, art. 5, para. 2.

B. THE SIGNIFICANCE OF AGENTS IN THE CURRENT DEFINITION OF A PERMANENT ESTABLISHMENT UNDER ARTICLE 5

With the establishment of the first tax treaties came the realization that a personal connection to the other contracting state was needed as justification for taxing the business enterprise.⁹⁹ Thus, an enterprise could be taxed by establishing either a physical or personal connection to another contracting state.¹⁰⁰ But the first tax treaties did not make a distinction between dependent and independent agents.¹⁰¹ Therefore, for a long period of time, the only way to establish a connection to another contracting state was through the use of a PE. However, this problem disappeared when the League of Nations at the first draft convention made a distinction between independent and dependent agents, which "represented an extension of residence-state taxation of business profits."¹⁰² As a result, the structure of paragraph five under Article Five of the OECD model treaty provides an alternative test on whether a business enterprise has a PE in a particular contracting state.¹⁰³ Therefore, agency law only becomes an important consideration if an enterprise has not previously met the definition of a PE.¹⁰⁴

The 1933 League of Nations draft contained the first enumerated definition of an independent agent.¹⁰⁵ In contrast, both the Mexico and London model treaties expressly maintained that an independent agent does not constitute a PE.¹⁰⁶ Thus, the distinction between an independent or dependent agent is significant for purposes of the PE requirement, since an agency relationship might constitute a PE if a dependent agent is involved, and he operates from a fixed place of business.¹⁰⁷ Consequently, unlike the "fixed" place of business requirement, where agency law is not a relevant consideration,¹⁰⁸ the status of agents in carrying out the primary objectives of a business is crucial and hence must be distinguished between dependent and independent means for determining whether a PE exists.

The defining characteristics of independent agents are: 1) they act within the ordinary course of their own business operations when acting on behalf of the enterprise;¹⁰⁹ and 2) they must be independent of the enterprise both legally and economically.¹¹⁰ Thus, legal independence re-

99. See SKAAR, *supra* note 24, at 76.

100. *Id.*

101. *Id.* at 77-78.

102. *Id.* at 82.

103. OECD Commentary to Article 5, *supra* note 79, para. 5, cmt. 35, at 80.

104. *Id.*

105. See SKAAR, *supra* note 24, at 86 (stating that the distinction between independent and dependent agents generally only applied to model treaties, not tax treaties).

106. *Id.* at 94.

107. BLESSING, *supra* note 23, ¶ 3.02[1][b][iv], at 3-26.

108. *Id.* ¶ 3.02[1][b][ii], at 3-18.

109. *Id.* ¶ 3.02[3][b][iv], at 3-56; see OECO Commentary to Article 5, *supra* note 79, para. 6, cmt. 37, at 81.

110. OECD Commentary to Article 5, *supra* note 79, para. 6, cmt. 37, at 81. Cf. Rev. Rul. 87-41, 1987-1 C.B. 269 (listing twenty factors that differentiate an employee from an

quires that the agent's commercial activities that he performs on behalf of the enterprise must not be "subject to detailed instructions or to comprehensive control" by the enterprise.¹¹¹ Likewise, economic independence is satisfied if the independent agent bears entrepreneurial risk.¹¹² Furthermore, whether an agent is independent or dependent generally depends on the ownership of the equipment that he will be using on his assignment. If the principal owns the equipment, the agent most likely will be classified as dependent. Otherwise, he is independent. Some common examples of independent agents include brokers and general commission agents.¹¹³

Moreover, in relation to independent agents, there has been some discussion concerning the actual meaning of the phrase "acting within the ordinary course." Specifically, the discussion has focused on whether an industry standard should be adopted that is analogous to the customs practiced in a customary trade,¹¹⁴ or whether these activities need to be further distinguished based on either their common or civil law context.¹¹⁵ However, to date the definition remains unchanged.

In contrast, dependent agents act on behalf of the enterprise and must frequently exercise their authority to negotiate and conclude contracts in the name of that enterprise.¹¹⁶ Distinguishing between the two is crucial, because under the "Agency Rule, independent agents do not give rise to a permanent establishment, whereas dependent agents [might]."¹¹⁷ The OECD model treaty of 1963 and its commentaries are helpful in this distinction because they define the scope of the agency clause and they formulate the basic definition of a dependent agent.¹¹⁸ Under this definition, emphasis was placed on the agent's authority and frequency to enter into and conclude contracts on behalf of the principal.¹¹⁹ For exam-

independent contractor, which is analogous to the factors that might be relevant in determining whether an individual or entity is legally or economically independent).

111. OECD Commentary to Article Five, *supra* note 79, para. 6, cmt. 38, at 81.

112. *Id.*

113. See Article 5, *supra* note 45, para. 6, at 28.

114. *Bundesfinanzhof*, decision of Mar. 24, 1995, BStBl 1995 II 238, *rev'g* Tax Court of Cologne, Entscheidungen der Finanzgerichte 1994 138 (Germany, art. II(1)(I)(v)) (a German Federal Tax Court decision concluding that agency activities must be further tested against industry practice to determine whether they were in the ordinary course of business despite the agency activities closely following the wording of the OECD model treaties). *Accord* Bundesfinanzhof, decision of Sept. 23, 1983, BStBl 1984 II 94 (Container-Chassis); Bundesfinanzhof, decision of Apr. 30, 1975, BStBl 1975 II, 626 ("ordinary course" requirement met by insurance agent). See generally Dr. Friedrich E.F. Hey, *German Court Holds Subsidiary Was Permanent Representative of Parent*, 6 J. INT'L TAX'N 132 (1995).

115. See John F. Avery Jones & David A. Ward, *Agents as Permanent Establishments Under the OECD Model Tax Convention*, 33 EURO. TAX'N 154, 156-169 (1993) (explaining the relationship between paragraphs five and six of Article Five of the OECD model treaty within the context of either a civil or common law framework); see also Sidney Roberts, *The Agency Element of Permanent Establishment: The OECD Commentaries from the Civil Law View (Parts 1 and 2)*, 1993 Intertax 396, at 488, 497 (1993).

116. Article 5, *supra* note 45, para. 5, at 27.

117. BLESSING, *supra* note 23, ¶ 3.02[3][b][iv], at 3-56.

118. See SKAAR, *supra* note 24, at 97.

119. *Id.*

ple, under the U.S. Treasury Regulations, a dependent agent regularly "exercise[s] his authority to negotiate and conclude contracts" if the authority is exercised with some degree of "frequency over a continuous period of time."¹²⁰ Furthermore, it was irrelevant what kind of relationship personnel had with third parties or whether the "dependent agent is authorized to conclude contracts [in the name of the company], if he works at the fixed place of business."¹²¹

In addition to hiring agents, the leasing of business equipment is also increasingly being considered as an option for conducting business more efficiently in our high-tech environment. Today, corporations routinely lease out their business equipment or facilities to other businesses because it is cheaper and it helps facilitate business dealings between the two companies. Generally, the leasing of equipment does not constitute a PE of the lessor if the contract is limited to mere leasing.¹²² Furthermore, there is no PE if the lessor provides personnel to maintain and operate the equipment, as long their sole responsibility is the maintenance of that equipment.¹²³ But if these personnel participate in decisions regarding which activities the equipment is best suited for, or if they inspect or service equipment that is under the control of the lessor, then it is likely that these activities would now constitute a PE because they are entrepreneurial in nature.¹²⁴

Consequently, where a person is acting on behalf of an enterprise, and habitually exercises his authority to conclude contracts in the name of that enterprise, that enterprise is deemed to have a PE in the contracting state where those activities took place, unless those activities were of a preparatory or auxiliary nature.¹²⁵

C. PREPARATORY AND AUXILIARY ACTIVITIES EXCLUDED FROM THE DEFINITION OF A PERMANENT ESTABLISHMENT

Some business activities, even if carried on through a fixed place of business, do not constitute a PE. These activities typically include the use of facilities for the storage or purchase of goods.¹²⁶ However, in our high-tech world, the most important PE exclusion that businesses rely on is the exclusion from taxation that results from engaging in activities that are of

120. Treas. Reg. § 1.864-7(d)(1)(ii) (2001).

121. OECD Commentary to Article 5, *supra* note 79, para. 1, cmt. 10, at 72.

122. *See id.*, para. 1, cmt. 8, at 71-72.

123. *Id.*

124. *Id.*

125. *See* BLESSING, *supra* note 23, ¶ 3.02[3][b][v], at 3-72. According to the OECD Commentary, the authority to negotiate contracts, without concluding them, was not enough for a PE to be created under agency law since the agent did not possess enough authority to bind the enterprise's participation in the activity. *See* OECD Commentary to Article 5, *supra* note 79, para. 5, cmt. 32, at 79-80. For a discussion of preparatory or auxiliary activities, see *infra* part IV(C), nn. 127-131.

126. *See* Article 5, *supra* note 45, para. 4(a),(d), at 27.

a preparatory or auxiliary nature.¹²⁷ Although these activities may contribute to the productivity of the enterprise, they are excluded from taxation because they are “so remote from the actual realization of profit” to accurately and fairly “allocate any profit to the fixed place of business.”¹²⁸ The decisive characteristic, which determines whether a specific activity is preparatory or auxiliary, is whether the activity forms “an essential and significant part of the activity of the enterprise as a whole” as to warrant taxation.¹²⁹

But an activity that is identical in scope to the general business purpose of the enterprise would not be considered preparatory or auxiliary since it is essential to the functioning of the organization.¹³⁰ For most companies, advertising is generally considered to be a preparatory or auxiliary activity, although it can sometimes be essential to the continued growth of a business in a competitive industry. Otherwise, without this exclusion for non-essential activities, practically every business entity in the world would be subject to the PE requirements since they all promote their businesses through advertisements.

Consequently, classifying a business activity as preparatory or auxiliary is the best means of ensuring that the company will not be subject to the PE requirements. However, an activity that is essential to the operations of the enterprise and thus meets the basic definition of a PE will not necessarily result in taxation. First, there must be business profits that are attributable to that PE and can be calculated with reasonable accuracy.

D. THE OTHER ELEMENT NECESSARY FOR THE IMPOSITION OF TAX
ON A PERMANENT ESTABLISHMENT: BUSINESS PROFITS
UNDER ARTICLE VII OF THE OECD MODEL
TAX CONVENTION

Article VII of the OECD model treaty, which deals with business profits, is a corollary to the PE concept found under Article V.¹³¹ Therefore, once the elements of a PE have been met, the enterprise must have business profits associated with that PE before the tax authorities will assess a tax liability against the foreign enterprise. “The question of which jurisdiction” had the authority to tax “business profits” was the primary issue that was addressed when the “problem of double taxation initially arose.”¹³² However, there is currently “no consensus among the OECD member countries as to the correct interpretation of Article VII.”¹³³ As a

127. *Id.* para. 4(e); see also OECD Commentary to Article 5, *supra* note 79, para. 4, cmt. 21, at 76.

128. OECD Commentary to Article 5, *supra* note 79, para. 4, cmt. 23, at 76-77.

129. *Id.*, para. 4, cmt. 24, at 77.

130. *Id.*

131. See Model Tax Convention on Income and on Capital, art. 7, preliminary remarks, cmt. 1, at 88 (June 1998 condensed version) (OECD Comm. On Fiscal Affairs) [hereinafter OECD Commentary to Article 7].

132. See SKAAR, *supra* note 24, at 76.

133. See OECD, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions*, general principles for attributing profit to a permanent es-

result, it is possible that the current interpretation of Article VII will lead to less than single taxation, or worse, double taxation.¹³⁴ But determining whether a particular enterprise has a PE is only the first part of the analysis. Assuming that a business enterprise does have a PE in a particular country, the second part of the analysis involves calculating the business profits, if any, which are attributable to that PE and are thus taxable.¹³⁵ Consequently, both Articles V and VII must be addressed simultaneously to avoid double taxation. In addition, once a PE exists, the profits of the enterprise must be characterized as either "business profits," which are taxed at the local tax rate in effect where the PE is located, or for example, as "royalties," which are taxed according to the withholding rate specified in the tax treaty with that particular country.¹³⁶

To the extent that the source state is permitted to tax business profits under a tax treaty, it is given preference as the primary taxing jurisdiction.¹³⁷ Thus, "[a] core provision in all U.S. income tax treaties is that business profits derived by a resident of a Contracting State from activities connected with the other Contracting States are not taxable by the latter State unless the business enterprise has a PE therein."¹³⁸ However, only the profits attributable to that PE may be taxed.¹³⁹ Attribution can be established by the presence of strong economic links to a business enterprise such as through a PE. Thus, it is crucial to distinguish between business profits that are attributable solely to the PE from the business profits that are generated from the activities of the enterprise as a whole. To simplify this determination, the OECD developed a "functional analysis" test,¹⁴⁰ which required treating the PE as a separate and distinct enterprise, independent from the main enterprise, and engaged in the same or similar activities, which were performed by the enterprise under similar conditions, and then looking at the separate sources of profits that are derived from that jurisdiction.¹⁴¹ In other words, the "functional analysis"

tablishment, cmt. 17, at 6, at http://www.oecd.org/daf/fa/e_com/public_release.htm (Feb. 2001) [hereinafter Attribution of Profit to a PE].

134. *Id.*

135. *See id.* cmt. 21, at 7.

136. This assumes that there is a current tax treaty in effect with this particular country. Furthermore, some payments may be taken out of Article 7 by the rule stated in paragraph 7 of Article 7, which gives priority to any other Article that expressly deals with the specific type of income concerned. One type of income that is often mistaken for business profits is royalties. Under the OECD model treaty, royalties are generally taxed in accordance with Article 12. Royalties are defined under Article 12 as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including . . . any patent or trademark . . . or for information concerning commercial or scientific experience. *See* OECD, *Tax Treaty Characterisation Issues Arising From E-Commerce*, business profits and royalties, cmts. 9-10, at 4, at http://www.oecd.org/daf/fa/e_com/public_release.htm (Feb. 1, 2001).

137. BLESSING, *supra* note 23, ¶ 4.01[1], at 4-3.

138. *Id.* ¶ 4.02[1], at 4-47; *see also* Model Tax Convention on Income and on Capital, art. 7, para. 1, at 29.

139. Article 7, *supra* note 138, para. 1, at 29.

140. Attribution of Profit to a PE, *supra* note 133, art. 7(2) of the OECD Model Tax Convention, cmt. 25, at 8.

141. *Id.*, foreword, cmt. 2, at 3.

test was an attempt to determine the assets used and the risks assumed by the PE.¹⁴² Although legally these risks were borne by the business enterprise as a whole, this test required that the PE assume any risks that were inherent in, or created by, the PE's own functions.¹⁴³ Consequently, only the profits that would naturally be expected to flow from this smaller entity were taxable.¹⁴⁴ For example, assume that Company ABC has its primary operations in Country X but its head office was located in Country Y. Under the "functional analysis" test, the profits that would be attributable to the PE of ABC Company would be those of its head office if it were treated as a "separate enterprise under [similar] conditions and at prices [currently] prevailing in the ordinary market."¹⁴⁵

The rationale behind such a test was to provide the tax authorities with a simple and efficient way of administering and enforcing the compliance of the tax laws.¹⁴⁶ But critics claimed that the test was flawed because it created an incentive for businesses to engineer tax avoidance strategies such as setting up a PE that either made no profit or was never intended to make a profit.¹⁴⁷ To alleviate these concerns, a majority of U.S. income tax treaties now provide a general definition of business profits.¹⁴⁸ For example, the 1981 U.S. model treaty defines "business profits" broadly to include "income derived from any trade or business."¹⁴⁹ Likewise, the 1996 Treasury model tax treaty defines "business profits" as "income from any trade or business, including income derived by an enterprise from the performance of personal services, and from the rental of tangible personal property."¹⁵⁰ In contrast, the 1992 OECD model treaty does not specifically define the term, but the Commentary states that it includes all income derived in carrying on an enterprise.¹⁵¹ Moreover, there is "no specific period [of time] for which an enterprise must operate in a Contracting State in order to be considered to derive business profits."¹⁵² Thus, a period of time sufficient to give rise to a PE is all that is necessary.

In calculating the business profits that are derived from a PE, a deduction for actual expenses incurred must be allowed in arriving at the net profit of the PE.¹⁵³ Paragraphs two and three of Article Seven follow the

142. *Id.*, server creates a PE, cmt. 52, at 14.

143. *Id.*, art. 7(2) of OECD Model Tax Convention, cmt. 30, at 9, server creates a PE, cmt. 53, at 14.

144. *Id.*

145. OECD Commentary to Art. 7, *supra* note 131, para. 2, cmt. 11, at 91.

146. *See id.*, para. 1, cmt. 8, at 90.

147. *Id.*, para. 1, cmt. 7.

148. BLESSING, *supra* note 23, ¶ 4.02[4][b][i], at 4-105. Furthermore, many U.S. tax treaties define business profits by reference to the source of the profits where the trade or business is located, thus shielding certain types of income from tax, if such activity does not give rise to a trade or business. *See id.* at 4-105.

149. *Id.*

150. U.S. Model Income Tax Treaty, *supra* note 78, art. 7, para. 7, at 13.

151. BLESSING, *supra* note 23, ¶ 4.02[4][b], at 4-106.

152. *Id.*

153. OECD Commentary to Article 7, *supra* note 131, para. 3, cmt. 16, at 96; *see also* Article 7, *supra* note 138, para. 3, at 29.

basic rule laid out in Paragraph one which is important in accurately determining the amount of business profits that are generated from a PE. Consequently, Paragraph three states the general rule that is used for determining business profits, while Paragraph two requires that the business profits correspond to those profits that a separate and independent enterprise would have made.¹⁵⁴

Alternatively, business profits can be calculated using an apportionment formula. But although an apportionment of profits based on the total profits of the enterprise is permissible if it is customary in the contracting state, it is generally not viewed as a very reliable method since it equates the profits of a PE to an estimate of the profit that would be derived from engaging in an arm's length transaction.¹⁵⁵ Thus, a loss in tax revenue could result if the apportionment of profit attributable to the PE is significantly less than the profit generated from an arms length transaction. Similarly, other methods have been advocated as a solution to this problem, but the business enterprise still has the responsibility of accurately calculating its business profits. In summary, the tax authorities are generally satisfied as long as the apportionment or calculation of taxable profits closely approximates the amount that would have been produced on a separate account basis.¹⁵⁶ Moreover, this principle corresponds to the primary purpose of any income tax treaty, namely to provide certainty and consistent tax treatment for all transactions associated with an enterprise.

E. THE IMPORTANCE OF THE TAX TREATY IN THE PERMANENT ESTABLISHMENT FRAMEWORK

Generally, the concept of a PE is only relevant if a tax treaty is present. This principle can best be illustrated by the interrelationship between Articles V and VII of the OECD model treaty. Furthermore, income tax treaties serve three primary functions. First, they avoid the double taxation of income, property or property transfers, by allocating or limiting the right of the source or the residence country to tax income or property.¹⁵⁷ This results in the promotion of international trade by minimizing the threat of double taxation, which is caused by multiple jurisdictions asserting taxing authority over the same income.¹⁵⁸ Moreover, promoting international trade can best be accomplished by reducing source-based taxes.¹⁵⁹ Second, tax treaties alleviate discriminatory tax treatment of residents of the Contracting States.¹⁶⁰ Third, tax treaties permit reciprocal administrative assistance in the prevention of tax avoidance and tax eva-

154. OECD Commentary to Article 7, *supra* note 131, para. 2, cmt. 11, at 91.

155. OECD Commentary to Article 7, *supra* note 131, para. 4, cmt. 11, at 102.

156. OECD Commentary to Article 7, *supra* note 131, para. 4, cmt. 27, at 103.

157. Rev. Proc. 91-23, 1991-1 C.B. 534.

158. Blessing, *supra* note 23, ¶ 1.01, at 1-3.

159. *Id.* ¶ 1.01[1][b], at 1-6.

160. Rev. Proc. 91-23, 1991-1 C.B. 534.

sion.¹⁶¹ This can be accomplished by providing contracting states a structure in which to enforce their domestic tax laws thus leading to a reduction in tax evasion.¹⁶² Consequently, the achievement of either of these goals by eliminating or reducing the threat of double taxation is significant since most nations tax domestic corporations on their worldwide income, but foreign corporations are only taxed on the amount of income derived from sources within their boundaries through the concept of a PE.¹⁶³

But these tax treaty goals produce different results depending on whether the treaty partner is a developed country such as the United States or a developing country such as Barbados. Moreover, the viewpoint concerning the scope of the PE definition is also dependent on the type of country that is represented by a treaty. A developed country such as the United States prefers tax treaty provisions that create broad exceptions to the PE definition and provisions that minimize the amount of withholding taxes that would be assessed on income from capital and technology.¹⁶⁴ In contrast, a developing country such as Barbados must balance their need to attract and retain foreign capital and technology by reducing source-based taxation against their need for increased governmental revenues.¹⁶⁵

The U.S. model treaties generally conform to the OECD model treaties in both structure and terminology.¹⁶⁶ However, the current debate concerning the possible reformation of the PE requirement focuses only on the OECD model treaty, which emphasizes permanence and a preference for resident-based taxation.¹⁶⁷ In addition, the most significant change that occurred during the development of the U.S. model treaty, which was adopted from the OECD model treaty, was the departure from the "force-of-attraction principle." Thus, it resulted in source-state taxation of income only if it was attributable or effectively connected to a PE of the enterprise.¹⁶⁸

Regarding the interpretation of the Supremacy Clause of the U.S. Constitution,¹⁶⁹ the Supreme Court has held that a treaty, which is negotiated and ratified by the President, is equivalent to domestic law, and thus should be recognized as being the supreme law of the land.¹⁷⁰ Accordingly, by analogy, a tax treaty should be accorded the same status as the supreme law of the land, because it fits within the definition of a

161. *Id.*

162. Blessing, *supra* note 23, ¶ 1.01, at 1-3.

163. *Id.* ¶ 1.01[1], at 1-3. For a general discussion on the functions of income tax treaties, see Vogel, Shannon, & Doernberg, *United States Income Tax Treaties*, ¶¶ 1.1-1.2 (Kluwer).

164. *Id.* ¶ 1.01[1][a], at 1-6.

165. *Id.* ¶ 1.02[3][b], at 1-15.

166. *Id.* ¶ 1.02[4], at 1-19.

167. See SKAAR, *supra* note 24, at 70.

168. BLESSING, *supra* note 23, ¶ 1.02[4], at 1-20.

169. U.S. Const. art. VI, cl. 2.

170. See *Foster v. Neilson*, 27 U.S. (1 Pet.) 253, 314 (1829).

"treaty."¹⁷¹ Under I.R.C. § 7852(d)(1), neither a tax treaty nor "U.S. domestic tax law is entitled to preferential treatment" solely because it has the status as either a treaty or law.¹⁷²

Since tax treaties represent international obligations of contracting states, their terms should be interpreted based on the meaning that it has under the domestic law of the contracting state imposing the taxes to which the treaty applies.¹⁷³ Consequently, the starting point for interpreting any provision of a tax treaty is the "ordinary meaning" of the terms that are contained within the language of the treaty itself in light of its object and purpose.¹⁷⁴ But a problem develops when the terms used are out-of-date or are no longer applicable to current business practices. This problem is especially prevalent in the technology industry where considerable doubt now exists as to whether these tax treaties are current enough to deal with the newer technologies now used in global business operations. An example is Internet applications, which are supplemented with the help of a computer server and/or website.

V. THE ROLE OF COMPUTER SERVERS AND WEBSITES IN THE CONTROVERSY TO REVISE THE PERMANENT ESTABLISHMENT REQUIREMENT

The pace of technological innovations over the last few years has transformed the way corporations conduct their business operations to such an extent that many businesses now do a majority of their transactions from the convenience of their own desktop computers or laptops. Furthermore, the development of the Internet has only sped up this transformation. All that is required in the current high-tech environment is access to a relatively high-speed computer server and some basic knowledge of computer software.

The Internet is a "global electronic network, consisting of smaller, interconnected networks, which allows millions of computers to exchange information over telephone wires, dedicated data cables, and wireless links. The Internet links PCs by means of [computer] servers, which run specialized operating systems and applications designed for servicing a network environment."¹⁷⁵ A web site is a collection of web pages published by an individual or organization containing hypertext, which consist of annotated references, or hyperlinks to other web pages.¹⁷⁶ Moreover, the World Wide Web is "a massive collection of digital information resources stored on [computer] servers throughout the Internet."¹⁷⁷ A computer server is defined as a machine on which specific

171. See *Samann v. Comm'r*, 313 F.2d 461, 463 (4th Cir. 1963); see also *Am. Trust Co. v. Smyth*, 247 F.2d 149, 153 (9th Cir. 1957).

172. BLESSING, *supra* note 23, ¶ 1.03[1][a][i], at 1-22.

173. See *id.* ¶ 1.05[1][a], at 1-60.

174. See *id.* at 1-61; see also SKAAR, *supra* note 24, at 41.

175. *United States v. Microsoft Corp.*, 84 F. Supp.2d 9, 13 (D.D.C. 1999).

176. See *id.* at 14.

177. *Id.* at 13.

software is run.¹⁷⁸ Often the server is connected to the Internet via a network that enables businesses to perform a variety of tasks, such as storing and updating customer records, performing financial and tax calculations for a business, or accessing and sending information to other external users.¹⁷⁹ In summary, computer servers are designed to provide data, services, and functionality through a digital network to multiple users.¹⁸⁰

Traditionally, computer servers were very large and difficult to move; thus, they remained in a fixed location and were located in a distinct place. As a result, these servers generally met the “fixed” place of business requirement necessary to establish a PE. But new and improved technology capabilities have reduced the size of the average computer server, making it more mobile, thus enabling computer users constant access to their servers from wherever they may be working on a particular day. Complicating matters are the “smart” servers now on the market, which are able to execute all aspects of an enterprise’s daily business transactions such as: contracting with customers, receiving payments, and performing other desired services.¹⁸¹ Finally, these computer servers have created the controversial issue of what function they contribute to a specific business enterprise: are the functions performed by these computer servers characterized as “core” business activities, or are they more properly characterized as merely “preparatory and auxiliary” business activities?

As a result, these mobile computer servers have attracted the attention of the tax authorities, which view their enhanced capabilities as another threat to their ability to collect an adequate amount of tax revenues. But there are additional problems with respect to computer servers and the current definition of the PE requirement that are most disconcerting to the tax authorities. First, it is difficult to classify these mobile servers as constituting a fixed place of business, which is one of the primary requirements of a PE. A second problem is determining how much of a contribution the owners expect from the server in running the overall operations of the business. Will the server constitute the primary storage place for important functions such as customer records and inventory matters? Or will its role be more analogous to a back-up server, which is only used in an emergency? Finally, the issue of whether the computer server is managed solely by the owners of the enterprise which own it and carry on business through a website attached to that server or whether it is managed by an enterprise that is separate from the owners such as an internet service provider (“ISP”) must also be addressed. For example, an enter-

178. Ine Lejeune et al., *Does Cyber-Commerce Necessitate a Revision of International Tax Concepts?*, 38 EUR. TAX’N 50, 51 (1998).

179. Arthur J. Cockfield, *Should We Really Tax Profits from Computer Servers? A Case Study in E-Commerce Taxation*, 21 TAX NOTES INT’L 2407 (2000).

180. See *Microsoft*, *supra* note 175, at 13.

181. Robert Goulder, *International Fiscal Association’s World Congress Debates E-Commerce Taxation*, WORLDWIDE TAX DAILY, Sept. 11, 2000, LEXIS, 2000 WTD 176-2.

prise may conduct business over their website which is transmitted over a computer server operated by Yahoo or AOL. Under this scenario, since an ISP is generally not considered to be a dependent agent of the enterprise to which the website belongs, the activities of the enterprise will not constitute a PE.

In contrast, there are generally not any PE classification problems when a website is used by itself in a business, unless the website is stored and used on the primary computer server utilized by the business. The rationale for this result is that use of a website, which is a combination of software and electronic data, does not involve tangible property nor does it constitute a fixed place of business.¹⁸² But the use of a computer server may constitute a "fixed" place of business because it involves computer equipment and it has a physical location.¹⁸³ Furthermore, businesses today can get around the potential PE problems associated with operating a website by entering into web hosting contracts. Unlike the operation of a website, which is controlled exclusively by the business enterprise, web hosting contracts generally don't give the business enterprise owning the website any right to a particular space or control over the operation of the computer server since it is not at the disposal of the enterprise.¹⁸⁴ Consequently, a fixed place of business would not exist. However, if the enterprise has control over both its website and the computer server, there is a physical presence and a PE could exist.

Therefore, the distinction between using a website versus a computer server to conduct business is crucial in determining whether a PE exists because the business enterprise that operates the computer server may be different from the enterprise that carries on business through that website.¹⁸⁵ Furthermore, once software and data are stored and operated from a computer server at a given location, they contribute to the functions performed there.¹⁸⁶ After this occurs, a determination must then be made as to whether the enterprise is carrying on a business at that location by analyzing all of the business activities which have been carried on from that location.¹⁸⁷ For example, suppose Company ABC has several back-up servers, each operating in a different country, which may or may not be owned by the enterprise. It would be very difficult at any particular point in time to determine whether ABC's main computer server was performing a primary function in the conduct of the business enterprise, rather than only preparatory and auxiliary activities.¹⁸⁸

182. Working Party No. 1 on Tax Conventions and Related Questions (OECD), *The Application of the Permanent Establishment Definition in Context of Electronic Commerce: Proposed Clarification of Commentary on Article 5 of the OECD Model Tax Convention*, Annex, para. 2, 40 EUR. TAX'N 190, 192-193 (2000) [hereinafter Revised Draft].

183. See *id.* at 193.

184. *Id.*, para. 3, at 193.

185. *Id.*

186. *Id.* at 192.

187. *Id.*

188. *Id.*

Considerations such as these must be discussed and agreed upon if a modern PE definition is to emerge to guide Internet business operations into the twenty-first century. Consequently, there is an immediate need to re-evaluate the definition of a PE in light of these advancements. Furthermore, issues such as those discussed above are currently being analyzed and debated by numerous countries. Although no consensus has evolved from these meetings, a solution appears to be on the horizon. Leading the way in proposing a solution to the computer server dilemma and a possible modernization of the PE requirement is the OECD.

A. THE OECD SOLUTION

On December 22, 2000, the Committee on Fiscal Affairs of the OECD issued a final draft that summarized the changes made to the commentary on Article 5 of the OECD model treaty relating to the definition of a PE in the context of electronic commerce.¹⁸⁹ Specifically, the OECD clarified their position on when a computer server and/or website would constitute a PE. Consequently, the following is a brief summary of the five major resolutions that resulted from the efforts of Working Party No. 1 on Tax Conventions and Related Questions¹⁹⁰ ("Working Party No. 1") and thus represents a major breakthrough on this controversial issue. Accordingly, this final draft will now provide companies with guidance on these issues and the likely response from various tax authorities concerning specific electronic commerce transactions which might result.

First, Working Party No. 1 expressed their belief that a distinction must be made between a computer server, which may be set up at a fixed location so as to constitute a PE in certain circumstances, and the software and data that is stored on that computer equipment, despite the observation that fixed automated equipment operated by an enterprise may constitute a PE in the country where the equipment is located.¹⁹¹ Although the fixed automated equipment generally only applies to vending and gaming machines, by analogy, it is possible that this exception could be extended to a computer server.¹⁹²

But it is this analogy that currently divides certain OECD member countries. Their primary concern is whether a business can even be carried on through the use of a computer server, which that business controls

189. OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* (Dec. 22, 2000), at <http://www.oecd.org/dat/falecom/public-release.htm> [hereinafter "OECD Solution"]. For a summary of the changes to the commentary, see Patrick Donsimoni, *OECD Committee Changes Definition of Permanent Establishment for E-Commerce*, WORLDWIDE TAX DAILY Jan. 24, 2001, LEXIS, 2001 WTD 16-3.

190. Working Party No. 1 on Tax Conventions and Related Questions is a subsidiary body of the OECD Committee on Fiscal Affairs and is responsible for drafting changes to the OECD Model Tax Convention.

191. OECD Solution, *supra* note 185, para. 42.4, at 5; *see also* OECD Commentary to Article 5, *supra* note 45, para. 1, cmt. 10, at 72-73.

192. OECD Commentary to Article 5, *supra* note 80, para. 1, cmt. 10, at 72-73.

and operates. Some countries believe it can, and use the existing OECD Commentary as support, which expressly recognizes that the business of an enterprise may be carried on through the use of automatic equipment.¹⁹³ However, other countries believe that business cannot be carried on through the use of a computer server used for electronic commerce operations since a computer server is vastly different from a vending or gaming machine.¹⁹⁴ Furthermore, these countries believe that the location of the computer server is irrelevant since the customer has access to the products or services of the business wherever the Internet connection is located. Thus, the enterprise's electronic commerce business does not meet the "fixed place of business" requirement since their business is carried on, not through its computer server, but rather through its offices, warehouses, or other locations in which its income-generating activities take place.¹⁹⁵ As a general rule, a computer server can only constitute a PE if it remains in a fixed location. Furthermore, "in order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time."¹⁹⁶ Thus, it is irrelevant whether the computer server could be moved around; the more important question is whether the computer server was moved.¹⁹⁷ Furthermore, unless the business uses a primary computer server or a computer server "located in a single jurisdiction, it is quite likely that any particular transaction may go through alternative or multiple computer servers in multiple jurisdictions," thus complicating this analysis.¹⁹⁸

In addition, a complementary issue to the computer server analogy previously discussed has arisen concerning the necessity of human intervention in the context of a PE. The majority view, represented by Working Party No. 1, has concluded "that human intervention is not a requirement for the existence of a permanent establishment."¹⁹⁹ As support, they point to the language in Paragraphs two and ten of the Commentary to Article 5, neither of which state "that a business may not be at least partly carried on without personnel."²⁰⁰ However, focusing on the same language found in Paragraphs two and ten of the Commentary to Article 5 for support, a minority view surfaced arguing that "some human interven-

193. *Id.* According to the Commentary to Article 5, some of the OECD countries (none of which are specifically identified) assume that a computer server is analogous to the examples listed in the Commentary regarding automatic equipment such as vending and gaming machines. *Id.*

194. *Id.* But according to the Commentary to Article Five, other OECD countries (none of which are specifically identified) believe that vending and gaming machines are different from computer servers since these types of machines are located in a fixed place and these machines enter into completed transactions with customers to provide goods and services. *Id.*

195. *Id.*; para. 1, cmts. 4-5, at 70-71.

196. OECD Solution, *supra* note 4-5, at 70-71.

197. *Id.*

198. Pamela M. Jensen, *Proposed Guidance on Selected Issues in Cross-Border Electronic Commerce Transactions*, WORLDWIDE TAX DAILY Sept. 26, 2001, para. 79, at 16, LEXIS, 2001 WTD 187-15.

199. OECD Solution, *supra* note 185, paras. 9-10, at 3.

200. *See id.*, paras. 10-13, at 3-4.

tion was required for a permanent establishment to exist.”²⁰¹ But Working Party No. 1 weakened the minority position on this issue by pointing out that the adoption of their point of view, that some human intervention is required, “could mean that, outside the electronic commerce environment, important and essential business functions could be performed through fixed automated equipment located permanently at a given location without a PE being found to exist, a result that would be contrary to the object and purpose of Article 5.”²⁰² Consequently, the presence of personnel operating a computer server at a particular location is not necessary for the existence of a PE.²⁰³

Second, an Internet website cannot constitute a fixed place of business and hence a PE, because a website is only “a combination of software and electronic data that does not, in itself, involve any tangible property.”²⁰⁴ Moreover, since no tangible property exists in conjunction with a website, “the enterprise does not have a physical presence at that location,” even if the enterprise can show that its website was “hosted on a particular computer server at a particular location.”²⁰⁵ In contrast, because a computer “server on which the web site is stored” and used is a piece of computer equipment that has a physical location or presence, it may constitute a “fixed place of business of the enterprise that operates that server.”²⁰⁶ Moreover, if an enterprise which conducts “business through a web site also owns or leases and operates the server on which the web site is stored and used, the enterprise could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.”²⁰⁷

Third, a distinction must be made between a website and the computer server on which the website is stored “since the [business] enterprise that operates the [computer] server may be different from the enterprise that carries on business through the web site.”²⁰⁸ “For example, it is common for the web site through which an enterprise carries on its business to be hosted on the [computer] server of an Internet Service Provider (“ISP”).”²⁰⁹ This arrangement usually will not constitute a PE of the business enterprise that conducts electronic commerce transactions through a website operated by one of the these servers (which are owned and operated by ISPs). One reason is that the contract between a business enterprises and an ISP typically does not result in the computer server and its location being at the disposal of the business enterprise. Furthermore, the ISP is not an agent of the business enterprise to which the web-

201. *Id.*, paras. 8-10, at 3.

202. *Id.*, para. 13, at 4.

203. *See id.*, para. 42.6, at 6.

204. *Id.*, para. 42.2, at 5; *see also* Revised Draft, *supra* note 178, at 192-93.

205. OECD Solution, *supra* note 185, para. 42.3, at 5; *see also* Revised Draft, *supra* note 178 para. 3, at 193.

206. OECD Solution, *supra* note 185 para. 42.2, at 5.

207. *See id.*, para. 42.3, at 5; *see also* Revised Draft, *supra* note 178 para. 3, at 193.

208. OECD Solution, *supra* note 185 para. 42.3, at 5.

209. *Id.*

site belongs.²¹⁰ A complementary issue that is also raised when dealing with a computer server and an ISP is whether the latter is considered a dependent or independent agent of the business enterprise.²¹¹ Generally, an ISP is not considered a dependent agent of the business enterprise since they have no authority to negotiate and conclude contracts in the name of that enterprise.²¹² Consequently, since an ISP hosts the websites of many different business enterprises, they are generally classified as an independent agent acting in the ordinary course of business.²¹³ Moreover, because "all Internet servers are linked in a global network that is designed to provide flexible routing and backup capabilities," computing functions may be moved from one computer server to another, thus resulting in a business "not know[ing] the routing or processing location for its electronic commerce transactions."²¹⁴ Finally, it is also clear under Article Five that a website cannot constitute a PE since the website through which a business enterprise carries on its business is not a "person" as defined in Article Three.²¹⁵

Fourth, certain preparatory or auxiliary electronic commerce operations would not constitute a PE, even if these activities were performed through the use of a computer server.²¹⁶ Whether a particular activity would be considered preparatory or auxiliary is determined on a case-by-case basis.²¹⁷ Examples of activities that would generally be regarded as preparatory or auxiliary include: 1) providing a communications link between suppliers and customers; 2) advertising goods and services over a website; 3) relaying information through a mirror server strictly for security or efficiency purposes; 4) gathering market data for a particular enterprise; and 5) supplying information to various external users.²¹⁸ Since a computer server and a website allow consumers to interact directly with electronic commerce businesses, a "server [is functioning] more like a communications device than a place at which business is carried on."²¹⁹ Consequently, these communication functions, as well as the other limited exceptions listed above, are "the type of preparatory and auxiliary activity that, in the traditional treaty context, do not create a permanent establishment, and thus would not be subject to taxation."²²⁰

210. *Id.*, para. 42.10, at 7.

211. For a discussion about the distinction between independent and dependent agents, see *infra* Part IV(B).

212. OECD Solution, *supra* note 185 para. 42.10, at 7.

213. *Id.*

214. Pamela M. Jensen, *Proposed Guidance on Selected Issues in Cross-Border Electronic Commerce Transactions*, WORLDWIDE TAX DAILY Sept. 26, 2001, paras. 78-79, at 16, available at LEXIS, 2001 WTD 187-15.

215. *Id.*

216. OECD Solution, *supra* note 185, para. 42.7, at 6.

217. *Id.*

218. *Id.*

219. Pamela M. Jensen, *Proposed Guidance on Selected Issues in Cross-Border Electronic Commerce Transactions*, WORLDWIDE TAX DAILY Sept. 26, 2001, para. 76, at 16, available at LEXIS, 2001 WTD 187-15.

220. *Id.*

But if these same functions formed “an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment” then a PE would exist, as long as the computer server constituted a fixed place of business of the enterprise.²²¹ Functions performed by a computer server related to a sale, such as concluding a contract with a customer, processing the payment, or delivering the product, will generally exceed the merely preparatory or auxiliary threshold.²²² But, “what constitutes a core function of the enterprise” has been and continues to be the subject of much debate.²²³ For example, an ISP that operates its own computer servers for the purpose of hosting websites or other computer applications for other business enterprises would constitute an essential function and thus would not be considered merely a preparatory or auxiliary activity.²²⁴ In contrast, the activities of a business enterprise that uses a computer server to sell products through the Internet would generally be classified as a preparatory or auxiliary activity that is analogous to advertising.²²⁵ Finally, “a web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site.”²²⁶

However, much of the uncertainty surrounding the issue of when a computer server will constitute a PE has been reduced as a result of the OECD consensus. The ability to relocate computer equipment such as computer servers should reduce the risk that taxpayers with electronic commerce operations will be found to have a PE when they did not intend for their operations to be classified as such.²²⁷ In addition, “circumstances where a taxpayer would want to have income attributed to a country where its computer equipment is located that result can be achieved through the use of a subsidiary even if no permanent establishment is considered to exist.”²²⁸ Furthermore, it is crucial that taxpayers be able to avoid being put in the situation of having a PE in a country without first having a physical presence in that country.²²⁹ The conclusion that “a web site cannot, in itself, constitute a permanent establishment” ensures this result.²³⁰

221. OECD Solution, *supra* note 185, para. 42.8, at 6.

222. *Id.*, para. 42.9, at 6-7.

223. Different countries hold contrasting views on what constitutes the core functions of a business enterprise. For example, some countries have concluded that sales functions performed through a computer server constitute a “place of business” and hence are a PE. But other countries have reached the exact opposite conclusion by deciding that such sales functions are more properly classified as a communication tool and hence a preparatory or auxiliary activity. Revised Draft, *supra* note 178, para. 14, at 194. For a discussion of how other countries have addressed this classification issue, see *infra*, Part V(B) below.

224. OECD Solution, *supra* note 185, para. 42.9, at 6.

225. *Id.*

226. *Id.*, para. 6, at 3.

227. *Id.*, para. 7, at 3.

228. *Id.*

229. *Id.*

230. *Id.*

Although many of the OECD member countries have agreed in principle to these resolutions,²³¹ some countries such as the United Kingdom have reserved the right to provide their own unique rules for certain electronic commerce operations or situations.²³² Consequently, there is still much uncertainty on the issue of whether a computer sever constitutes a PE, since many countries have not yet had the opportunity to address this specific issue in the context of the recent solution put forth by the OECD. Moreover, it remains unclear how non-OECD countries will resolve this same issue. But one thing has emerged from the countries that have already been exposed to this issue: there is very little uniformity among the various approaches adopted by countries as a means to resolving this current dilemma.

B. REACTIONS BY OTHER COUNTRIES TO THE COMPUTER SERVER ISSUE

The countries that have already considered the computer server issue can be separated into one of three categories: 1) countries that have conclusively decided that neither a website nor a computer server would constitute a PE for tax purposes; 2) countries that have held that either a computer server or website would constitute a PE for tax purposes; or 3) countries that have not yet had an opportunity to address this issue but are inclined to agree with the OCED.

Germany was one of the first countries that attempted to clarify the computer server issue by tentatively holding that the mere installation of an Internet server in a foreign jurisdiction by a German company did not constitute a PE and thus warrants taxation. Instead, the Supervisory Finance Office of Karlsruhe, in conjunction with an agreement between all of the heads of the international tax departments of the Federal Finance Ministry and the state finance ministries, decided that a more appropriate treatment was to classify the installation of the computer server as a preparatory or auxiliary activity under Article 5, paragraph 4, of the OECD

231. Both Spain and Portugal have dissented to the consensus view advocated by the other OECD countries that a website cannot, by itself, constitute a PE and that a website hosting arrangement generally does not result in a PE of the enterprise that carries on business through that website. In contrast, neither Spain nor Portugal considers a physical presence to be a requirement necessary for a PE to exist in the context of electronic commerce. Therefore, in certain circumstances, both Spain and Portugal believe that an enterprise carrying on business in a country through a website could be treated as having a PE in that country. OECD Solution, *supra* note 185, para. 6, at 3. For additional discussion on both Spain and Portugal's viewpoints on the computer server issue, see *infra*, Part V(B) below.

232. The United Kingdom has concluded that neither a website nor a computer server is sufficient by itself under any circumstances to constitute a fixed place of business and therefore could not be characterized as a PE for tax purposes, if the business was utilizing a computer sever in association with a website to conduct business transactions over the Internet. See United Kingdom Inland Revenue, *U.K. Inland Revenue Call for Debate on Tax Treatment of Websites*, WORLDWIDE TAX DAILY Apr. 12, 2000, at LEXIS, 2000 WTD 71-27. For additional discussion on the United Kingdom's viewpoint on the computer server issue, see *infra*, Part V(B) below.

model treaty.²³³ Furthermore, this pronouncement raised another fundamental question concerning which activities are preparatory or auxiliary in nature. In relation to the PE requirement, what happens when a customer's purchase order is accepted and fulfilled by a computer server or website?²³⁴ Based on these facts, it appears that these additional business activities would cross the preparatory and auxiliary threshold, thus creating a PE.

The rationale for their decision was that no PE was created in the foreign country where the installation took place since the computer server only enabled the foreign customers to obtain general information about the company and submit orders.²³⁵ However, the German tax authorities did believe that a computer server fit the definition of a "fixed place of business," a primary element of a PE under Article 5, paragraph 1, of the OECD model tax treaty.²³⁶ Although this holding reflects the current viewpoints of the OECD member countries on this subject, it directly contradicts the German Supreme Court's so-called "Pipeline Decision", which held that a remote-controlled pipeline located in Germany constituted a PE.²³⁷ The Pipeline Decision was controversial and confusing because it defined a PE more broadly.²³⁸ It required that the PE *serve* the business enterprise; however, the OECD version only required that the business be carried on *through* the PE.²³⁹ Moreover, to "serve" an enterprise included activities that were essential to the enterprise as well as activities that were auxiliary or insignificant.²⁴⁰ Finally, the German Supreme Court also concluded that personnel were not necessary for a PE to exist.²⁴¹

Similarly, the United Kingdom came to the same conclusion as Germany by concluding that "in no circumstances do [computer] servers, of themselves or together with web sites, constitute permanent establishments of [electronic commerce retailers] and intends to make an observation to that effect when the changes to the Commentary on Article 5 are included in the Model Tax Convention."²⁴² Furthermore, the United Kingdom maintains this opinion regardless of whether the computer server is "owned, rented, or otherwise at the disposal of the [enterprise]."²⁴³ It appears that their viewpoint was driven by economic factors such as the desire to attract more electronic commerce business.²⁴⁴

233. Freidrich E.F. Hey, *German Tax Authorities Rule That Server Does Not Constitute PE*, WORLDWIDE TAX DAILY at 2, Aug. 10, 1999, at LEXIS, 1999 WTD 153-1.

234. *Id.*

235. *Id.*

236. *Id.*

237. Marc Lampe, *Broadening the Definition of a Permanent Establishment: The Pipeline Decision*, 38 EUR. TAX'N 67, 67 (1998).

238. *Id.* at 68.

239. *Id.* (emphasis added).

240. *Id.*

241. *Id.*

242. OECD Solution, *supra* note 185, para. 14, at 4.

243. *Id.*; see also OECD Solution, *supra* note 185, para. 14, at 4.

244. Donsimoni, *supra* note 185, at 2.

Likewise, Argentina holds a view similar to the United Kingdom and Germany, that a computer server could not be characterized as a PE because it is not a "fixed place of business."²⁴⁵ Moreover, they believe that in most instances, a website also would not meet the definition of a PE since it involves preparatory and auxiliary activities.²⁴⁶ However, a different result would occur if their website had the capabilities to process purchase orders, finalize sales, and collect payments from customers.²⁴⁷ Italy also shares the opinion that the presence of a website is generally not enough to characterize it as a PE.²⁴⁸ However, Italy has also taken the complementary position that a "smart" server, which performs actions similar to those performed by an agent, may be sufficient to create a PE.²⁴⁹ Moreover, a Dutch advisory group has recommended to the Dutch tax authorities not to regard an electronic presence through a computer server as a PE in the Netherlands.²⁵⁰ Finally, India has recently changed its position regarding this issue and now holds a view similar to the OECD consensus opinion that a computer server will only constitute a PE in very limited circumstances. Specifically, the Indian government is likely to tax the electronic commerce transactions of a foreign company operating in India only if the transactions are made through a dedicated computer server based in India.²⁵¹

In contrast, it is very likely that a computer server located in China will give rise to a PE, although a website would not.²⁵² Thus, this view would

245. Silvia R. Sanusian, *Taxation and E-Commerce: Preliminary Notes on the Notion of 'Permanent Establishment' From an Argentine Perspective*, 21 TAX NOTES INT'L 1845, 1851 (2000).

246. See *id.*

247. See *id.* at 1849.

248. Iacopo Monaci Naldini, *Italian Tax Treatment of E-Commerce Transactions*, 21 TAX NOTES INT'L 1860, 1861 (2000).

249. See Ann Fairpo, *Electronic Commerce: U.K. Policy Document*, 1 TAX PLANNING INT'L E-COMMERCE, No. 5, at 4 (1999). However, this definition of agency is inconsistent with the reference to an agent as a "person" as defined in Article Five of the OECD Model Treaty.

250. See Willem C.B. Van Wettum & Paul R.C. Kraan, *Taxation of Electronic Commerce in the Netherlands*, TAX PLANNING INT'L E-COMMERCE, No. 5, at 16 (1999).

251. CT Mahabharat, *India Appears Likely to Reverse Course on E-Commerce Taxation*, WORLDWIDE TAX DAILY, Sept. 6, 2001, at LEXIS, 2001 WTD 173-10. However, as an example of India's initial conclusions regarding this issue before their sudden change of heart, consider the Indian Tax Department's recent determination that the activities of CRS Company ("CRS"), relating to the booking fees received from airlines which are associated with a computerized airline reservation system, constitute taxable business income and hence a "virtual" PE in India, notwithstanding the fact that neither the airlines making the payment nor CRS reside in India. See Daksha Baxi & Bijal Shah, *Electronic Commerce Taxation Evolves in India*, 21 TAX NOTES INT'L 1923, 1931 (2000). Furthermore, the tax authorities also determined that an Indian marketing firm, IMC, which provided equipment to the travel agents, constituted a dependent agent of CRS, thereby constituting an Indian PE of CRS. *Id.* For a more detailed discussion of this ruling as well as a discussion on the feasibility of adopting a "Base Erosion Approach" as a solution to the problems associated with the allocation of tax revenues between residence and source-based jurisdictions, see generally Richard L. Doernberg, *Electronic Commerce: Changing Income Tax Treaty Principles a Bit?*, 21 TAX NOTES INT'L 2417, 2419, 2424-30 (2000).

252. Jinyan Li, *E-Commerce Taxation in China*, WORLDWIDE TAX DAILY, Dec. 4, 2000, at 8, at LEXIS, 2000 WTD 233-12.

be consistent with the OECD Commentary on Article Five.²⁵³ Moreover, China's current tax treaties closely follow the OECD model treaty.²⁵⁴ For example, China broadly defines a PE that is closer to the definition under the United Nations Model Convention than the version adopted by the OECD.²⁵⁵ But, "strong opinions [have] been expressed that both a Web site and a computer server in China should be treated as a permanent establishment, where the Web site or computer server is equipped to complete the whole transaction."²⁵⁶ Although there is still some uncertainty regarding China's official position on the computer server issue and electronic commerce taxation in general, it is clear that China intends to preserve its reliance on source-based taxation and is committed to the principle of tax neutrality regarding electronic commerce transactions.²⁵⁷

Likewise, both Spain and Portugal have dissented from the consensus opinion of the OECD regarding websites and computer servers and believe that in the context of electronic commerce transactions, it is not necessary to have a physical presence in order to constitute a PE.²⁵⁸ Similarly, Australia has also recently concluded that website located on a computer server may constitute a PE depending on the circumstances.²⁵⁹ Therefore, an enterprise conducting business through a website located within these countries might be regarded as having a PE in that country.²⁶⁰

However, there are a number of countries that are undecided on this issue because they either lack a detailed set of PE rules, or their current tax infrastructure is unable to support electronic commerce transactions. Consequently, in the absence of such a framework, they are generally supportive of the current solution advocated by the OECD. One country that fits into this category is Brazil, a non-OECD country. Brazil is currently developing a comprehensive framework to address the tax issues associated with electronic commerce transactions, which should eliminate most of the problems encountered due to the lack of a detailed set of PE rules. In general, under Brazilian commercial law, the only way that a foreign business entity will be treated as having a Brazilian taxable presence is if it operates either through a fixed place of business, or it operates through a dependent agent who has the authority to bind the foreign enterprise to Brazilian contracts.²⁶¹ Moreover, due to its lack of detailed PE rules, there is no concept associated with business profits effectively

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

258. OECD Solution, *supra* note 185, para. 6, at 3.

259. See Howard J. Levine & David A. Weintraub, *When Does E-Commerce Result in a Permanent Establishment? The OECD's Initial Response*, 29 TAX MGMT. INT'L J. 220, 223, n.45 (2000).

260. *Id.*

261. Joseph Wolf & Thorsten Reelitz, *Brazilian Developments in E-Commerce Taxation Policies*, 21 TAX NOTES INT'L 1051, 1054 (2000).

connected with a trade or business located in Brazil.²⁶² Hence, questions such as whether a website or computer server located in Brazil constitute a taxable presence is subject to existing domestic tax laws.²⁶³ In principle, since a website does not involve the location of tangible assets in Brazil, it should not constitute a fixed place of business.²⁶⁴ But the result might be different if Brazilian Internet users can bind the foreign enterprise to contracts that are finalized on a website that is hosted on the computer server of a Brazilian ISP.²⁶⁵ Moreover, a computer server that is located in Brazil but is operated by a foreign enterprise involves a piece of equipment and a physical presence that most likely will be considered a fixed place of business.²⁶⁶

Similarly, France is another country that has not yet resolved this issue, but generally follows the positions advocated by the OECD.²⁶⁷ Thus, a website located in France would probably not be considered a PE in France, but the use of a computer server located in France might be considered a PE under certain circumstances, particularly if the foreign company uses "smart" software to conduct business in France, or if the computer server is maintained by French personnel.²⁶⁸

In addition, Canada has taken somewhat of a neutral stance on these issues and has thus far encountered similar problems experienced by both Brazil and France. Although the OECD recently clarified its position regarding the circumstances under which a computer server would be classified as a PE, Canada has not yet incorporated these recommendations into its modernization project regarding tax issues associated with electronic-commerce transactions. As a result, Canada's strategy relating to the use of a computer server in electronic commerce transactions can best be described as a "wait and see" approach, thus ensuring that its tax positions are consistent with those of other jurisdictions.²⁶⁹

Finally, several Asian-Pacific countries, in addition to India and China, have also started to address the significant challenges raised by the new electronic commerce environment. These emerging issues represent special problems for Hong Kong's source-based tax system.²⁷⁰ But although the government of Hong Kong is very interested in promoting electronic commerce, it has yet to take proactive steps in light of these challenges, suggesting that the first guidelines dealing with the taxation of electronic commerce in Hong Kong will have to come from the courts.²⁷¹ Likewise, the Japanese tax authorities have failed to address the specific issue of

262. *Id.*

263. *Id.*

264. *Id.*

265. *Id.* at 1055.

266. *Id.*

267. *Id.*

268. *Id.*

269. Jim Vincze & Randy Schwartz, *E-Commerce Taxation: A Canadian Update*, WORLDWIDE TAX DAILY, June 7, 2000, at 2, at LEXIS, 2000 WTD 152-9.

270. *See* Asia-Pacific, *supra* note 2, at 880.

271. *Id.*

whether electronic commerce transactions could constitute a PE. Informally, these tax authorities have suggested that the presence of a computer server in Japan might give rise to a PE.²⁷² Moreover, they attempt to analogize computer servers to the example given in the OECD Commentary to Article Five relating to vending machines.²⁷³ As a result, existing Japanese tax statutes and regulations have not yet been amended to reflect the current tax environment of electronic commerce transactions.²⁷⁴ Similarly, because the existing statutory and regulatory framework of Korea is closely parallel to the results advocated by the OECD regarding websites and computer servers, it is possible that the use of the Internet to conduct electronic commerce transactions will constitute a PE.²⁷⁵

In conclusion, these early decisions by these countries on the status of websites and computer servers under the existing PE rules are significant for two reasons. First, they provide businesses a basis from which to make investment decisions thus helping to facilitate the calculation of their tax liability. Second, and more importantly, they provide certainty in tax matters to companies engaged in electronic commerce transactions, which will impact the way industries conduct business over the Internet in the new-millennium.

C. THE CONSEQUENCES ON ELECTRONIC-COMMERCE CLIENTS OF
CONCLUDING THAT A COMPUTER SERVER IS A PE: THE
PROLIFERATION OF TAX HAVEN JURISDICTIONS

If the OECD were to conclude that a computer server constituted a PE, disastrous consequences would occur that could permanently change the way business is conducted over the Internet. "A principal concern of tax authorities is that the highly mobile nature of new internet technologies will lead to the proliferation of tax haven operations that will further erode their tax base."²⁷⁶ Moreover, the absence of tax treaties characterizes many of the popular tax haven countries, thus exacerbating the problem.²⁷⁷ Since few countries have tax treaties with tax havens, Internet-delivered sales of products or merchandise will generally not be subject to withholding tax.²⁷⁸ Instead, the company would probably only face a maximum tax rate of around 2% of its sales, considerably lower than the current withholding tax rates found in most tax treaties.

Yet, more subtle problems exist that would arise and indirectly affect a company's decision about whether to relocate to a tax haven to conduct business. First, countries would begin competing against each other to attract the most recognizable companies to their jurisdictions. This could

272. *Id.* at 884.

273. *Id.*

274. *Id.* at 880.

275. *Id.* at 886.

276. Ned Maguire, *Taxation of E-Commerce*, 47 JUNE FED. LAW. 24, 28 (2000).

277. *Id.*

278. *Id.*

lead to a potential shift in the balance of power of whole industries if they chose to transfer their operations to a tax haven, thus affecting the dynamics of those industries as well as the other industries in the countries where they were initially located. Second, companies that decide to relocate offshore would only pay minimal taxes as long they avoided a taxable presence in the countries they continued to have business relations with.²⁷⁹ As a result, the amount of tax revenue collected in these countries would decrease dramatically as these industries left their established home countries and headed for the greener pastures associated with tax haven countries. Finally, companies that decide to relocate offshore would only pay minimal taxes as long they avoided a taxable presence in the countries they continued to have business relations with.²⁸⁰

"According to the [OECD], a tax haven can be described as a jurisdiction actively making itself available for the avoidance of tax that would otherwise be paid in relatively high tax countries."²⁸¹ Furthermore, they "also serve the purpose of postponing the imposition of tax," rather than the evasion of tax.²⁸² Since business profits are generally only taxed when they are repatriated back to the home country as a dividend, "a tax sanctuary enables working capital to be used in its cheapest form."²⁸³ For example, using the low tax rates currently found in their tax treaties, both Ireland and Singapore have aggressively marketed themselves as Internet friendly to businesses.²⁸⁴

All tax havens generally have the following characteristics in common: 1) a relatively low tax rate or a non-existent one; 2) political stability; and 3) both physical and legal accessibility.²⁸⁵ For example, there are several reasons why Barbados is one of the most popular tax haven countries for conducting global business transactions. First, Barbados only subjects foreign enterprises²⁸⁶ to a maximum income tax rate of 2.5% on business profits up to 5,000,000 USD that are generated by a PE.²⁸⁷ All remaining profits above 5,000,000 USD are taxed on a decreasing tax rate scale that culminates at 1%. Another reason that Barbados is preferred as a tax haven is because of its "solid financial infrastructure," which provides companies another incentive to re-locate to a tax-friendly environment.²⁸⁸ Finally, under article V of its tax treaty with the United States, Barbados has reverted to the PE definition contained in the 1977 OECD

279. *Id.*

280. *Id.*

281. ANTHONY S. GINSBERG, *INTERNATIONAL TAX HAVENS* 5 (2d ed. 1997).

282. *Id.* at 6.

283. 1 WALTER H. & DOROTHY B. DIAMOND, *TAX HAVENS OF THE WORLD* INTRO-1 (1992).

284. Maguire, *supra* note 272, at 28.

285. CAROLINE DOGGART, *TAX HAVENS AND THEIR USES* 2 (rev. 1982).

286. Under Barbados law, foreign enterprises are commonly referred to as "international business companies."

287. See DIAMOND, *supra* note 279, at Barbados-3; see also DOGGART, *supra* note 281, at 10; GINSBERG, *supra* note 277, at 123.

288. See DOGGART, *supra* note 281, at 10. Cf. I.R.C. § 1 (1994) (providing that corporate tax rates begin at 15% and graduate to a maximum effective tax rate of 35%).

model treaty as a means to encourage offshore activities because it has a higher PE threshold than the 1980 United Nations model treaty.²⁸⁹ However, these tax haven countries have a common enemy in the OECD, who has set as one of their primary goals, the reduction and elimination in the increasingly popular practice of companies transporting their business operations to a tax haven solely to take advantage of the favorable tax rates offered.

To illustrate the tax consequences of the recent OECD resolution regarding the situations when the use of a computer server and website will constitute a PE, consider an enterprise that has global operations and has recently switched from the traditional method of conducting business over the telephone or through the mail system, to the Internet because of the lower costs and efficiencies associated with this new medium. Furthermore, assume this enterprise primarily conducts business over the Internet by advertising and selling products on their own website as well as the websites of other companies. Moreover, they utilize a variety of computer servers to facilitate these business transactions, some of which are located in the United States, but generally only operate out of their headquarters, which is located in a foreign jurisdiction. Up to this point, they have enjoyed a rather profitable existence and have paid their fair share in taxes. But suppose that the OECD now decides that a computer server constitutes a PE. How is this business enterprise likely to respond to this scenario?

The enterprise could adopt a tax minimization strategy by electing to transfer all of its business operations out of the United States and relocate them to a jurisdiction that has a low effective tax rate, preferably a tax haven country such as Barbados or the Cayman Islands. Consequently, as a result of this strategy, the United States will permanently lose out on all of the potential tax revenues that were associated with this profitable enterprise. In addition, it will be harder to regulate and eventually eliminate these tax haven countries, since new ones will constantly emerge until the supply for them equals the demand. Consequently, if the enterprise adopts this strategy, it is imperative that the computer servers utilized by the company are transported out of their current locations, which resulted in the characterization of a PE, and into a jurisdiction with low effective tax rates, since the OECD believes that the primary issue relating to computer servers is whether they have been moved.²⁹⁰ Moreover, since the tax that is imposed on business profits attributable to a PE is equivalent to the tax treaty rate for business profits, the tax liability that is owed by TGA in the new jurisdiction will likely have very little impact on their business operations.

Alternatively, the enterprise could decide to keep its operations in the United States and risk that the Internal Revenue Service will decide not to characterize their computer server use as income attributable from a

289. See GINSBERG, *supra* note 277, at 135.

290. OECD Solution, *supra* note 185, para. 42.4, at 5.

PE. But in order to succeed at this plan, the enterprise will have to prove that the use of various computer servers to generate sales only represents a minor aspect of their business operations and is thus more like a preparatory or auxiliary activity. Although the enterprise does a significant amount of advertising over websites, which the OECD has recently classified as a preparatory or auxiliary activity, they also generate revenues by selling products on these websites, an activity that is essential to their business. Moreover, many of these websites now have the capabilities to take and process orders from customers and accept their payment for products purchased. These activities clearly are essential to the success of a business enterprise. Thus, given the advance capabilities of these websites, it would be more advantageous from a tax standpoint if this enterprise transferred their business operations to a tax haven with a low effective tax rate such as Barbados, rather than take the risk of an unfavorable decision from the Internal Revenue Service by continuing to operate in the United States.

VI. CONCLUSION

The new millennium offers many challenges regarding the taxation of electronic commerce transactions that must be resolved. It is a foregone conclusion that the development of the Internet has transformed the way businesses operates. Traditionally, businesses conducted all of their transactions from a physical location that remained in one place. But the rapid advances in the technology industry have enabled many businesses to expand globally and thus reach a more diverse set of customers. Transactions can now be completed without the need to establish a physical presence in a particular jurisdiction. In addition, it is no longer necessary for businesses to precisely determine the location of the party they are transacting with since one of the primary characteristics of cyberspace is the lack of natural boundaries. Although this new technology has resulted in a more efficient business environment, it has created numerous tax issues that have yet to be resolved, such as the recent debate on whether the current definition of a PE should be modified to accommodate our new electronic commerce age, or whether the existing framework surrounding the current PE rule is sufficient and should thus be left intact. The moderator in the middle of this debate has been the OECD, an organization that has taken on the responsibility for coordinating the tax issues arising from electronic-commerce transactions.

There are many viewpoints concerning the possible revision of the PE concept, which has existed primarily as a threshold rather than a source rule. Its primary purpose was to have some mechanism for taxing the business profits of foreign enterprises. Some countries believe that the current PE requirement should be replaced to better reflect our new-found reliance on the use of the Internet as a means of conducting business transactions. In contrast, the OECD holds the belief that the current principles, which underlie both the current PE requirement and the

OECD model tax convention, are capable of being applied to electronic commerce transactions without substantial revision. As support, they focus on the longevity of the current PE requirement, which is embedded in over fifteen hundred tax treaties. Moreover, it has managed to stand the test of time. Any substantial changes to the traditional definition would cause unnecessary turmoil in global markets it is was suddenly replaced. Consequently, the recent consensus reached by the OECD of the situations when the use of a computer server will give rise to a PE will most likely influence the tax policies of numerous countries. This consensus can be seen in countries such as Germany, which has agreed with the position advocated by the OECD, and the UK, which has agreed to an extent with the basic position put forth by the OECD. Moreover, countries such as Brazil that do not have a tax framework currently in place to accommodate this new electronic media, are closely monitoring the OECD for new pronouncements to use as a model in the development and revision of their own tax structures.

The consensus reached by the OECD is that a website of a business will never constitute a PE, but a computer server could be a PE if the business owns or leases the server. In addition, this interpretation suggests that a prerequisite to the existence of a PE is disposal or control over the computer server. So far, this resolution has kept intact the two primary elements of a PE, which has origins that date back as far as the Prussian War. These two primary elements are the existence of a fixed place of business and the carrying on of a business through the performance of commercial activities. Whether these businesses have a PE will depend on the type of computer server used and the nature of the activities assigned to such a computer server.

Thus, it is imperative that the activities performed by the computer server be classified correctly in order to make a proper determination regarding the existence of a PE. Whether e-commerce operations carried on through a computer server are of a preparatory or auxiliary nature must be determined on a case-by-case basis taking into account whether the various functions performed by the computer server are essential. For example, advertising on a website is generally considered to be a preparatory or auxiliary activity. Hence, there is no PE. But websites that accept purchase orders, finalize sales, and collect payments would have a PE since these are essential functions of any business. In contrast, an empty server is similar to an empty building: neither constitutes a PE since no business is being conducted. But as computer servers become more innovative and thus capable of accomplishing more important business functions such as storing necessary customer information that can be recalled at the touch of a button, the classification issues regarding computer server functions as either essential or preparatory or auxiliary will become more complex. Consequently, the classification of business functions as either a preparatory or auxiliary activity remains the most popular and easiest way to get around the PE requirement.

Complicating matters is the complementary relationship that exists between the PE requirement and business profits. As a result, the increased emphasis placed on the potential revision of the PE requirement has resulted in less attention being focused on business profits. Therefore, determining whether an enterprise has any business profits is an important step since only the business profits attributable to a PE are taxable. But it is very difficult to accurately determine the level of business profits that is generated by a computer server since it generally performs many interrelated functions of an organization that cannot easily be classified according to importance. Some functions such as ordering inventory or processing purchase orders are more essential to the profitability of a business than other functions such as advertising, which are more preparatory or auxiliary in nature.

Furthermore, under the laws of most countries, transactions that result in business profits generally require some degree of physical presence in order to justify local taxation. Thus, a website that can be hosted in multiple jurisdictions and which can also be accessed from multiple locations generally will not provide the requisite amount of physical presence to impose taxes on the business profits that are derived from those activities. Likewise, with the increased mobility present in many computer servers today, concluding that a computer server was a PE would cause the long-held principle of taxing only in jurisdictions where there is a physical presence to disappear. Arriving at an acceptable solution that is fair to all countries is more difficult with the realization that most businesses strive to differentiate themselves from their competition. For example, core functions necessary to one Internet business could conceivably be classified as merely preparatory or auxiliary activities to the other business. As a result, only one of these Internet businesses will be subject to the PE rules. Thus, a lack of uniformity in the tax laws begins to emerge, a result contrary to one of the primary goals that was formulated by the OECD when it set out to address this situation several years ago.

Moreover, doing business in the electronic commerce age is also forcing a re-examination of whether it is more beneficial to have residence-based taxation or source-based taxation. Although this is far from settled, the Internet has transformed and effectively eliminated source-based taxation principles, thus depriving many taxing jurisdictions of revenues that they are entitled to. Complicating matters is the increasing mobility of many servers today. However, the end result would remain the same: a residence-based tax system. Likewise, concluding that a computer server may constitute a PE will have other pervasive tax consequences. Most notably would be the increasing attractiveness of tax havens attempting to entice businesses into transferring their operations to take advantage of their low effective tax rates. If a majority of a particular country's businesses suddenly decide to move to a jurisdiction with a lower tax rate, a massive shortage in tax revenues will accrue to the countries where these businesses previously were located. Accordingly, there will be intense

pressure on the tax authorities to prevent a further erosion of their tax base caused by these defections. For example, one of the most serious challenges currently facing tax authorities regarding the taxation of electronic commerce transactions is the removal of intermediaries in the supply of goods and services, commonly referred to as the disintermediation process. The removal of intermediaries has reduced the ability of the tax authorities to collect their share of the revenue generated by these transactions, thus limiting their control over the flow of commerce. Exacerbating the problem are manufacturers and producers who are increasingly dealing with customers directly over the Internet, regardless of their physical locations rather than through the more traditional physical office, typified by a "bricks and mortar" business. Consequently, because the property of an e-commerce business may consist only of a computer server rather than a physical office, there are significant issues as to whether the existing definition of a PE is relevant or useful.

As technology continues to make rapid advances and businesses begin to rely more and more on portable computer servers, which can be transported from location to location while performing essential business tasks, or multiple computer servers that make it difficult or impossible to determine which computer server performed the core functions necessary to the business, the definition of a PE will likely have to be modified again to reflect these trends. Otherwise, the PE requirement will be rendered obsolete since no business will be considered to have a fixed place of business. Moreover, there is an inverse relationship between computer server capabilities and their size. As they become smaller in size, their power and capabilities increase substantially. Before long, businesses will be able to do all of their transactions with a computer server capable of fitting in the palm of the hand, thus rendering irrelevant the "fixed" place of business requirement that is currently necessary for a PE. But if a business decides to use only one computer server and it remains in one location, then the argument for a PE is more compelling. Accordingly, because of these new OECD guidelines, the types of computer servers used and their respective locations will have to be selected with care to ensure that corporate tax liabilities are minimized.

Although the current definition of a PE provides uniformity and certainty to most situations, it is functionally inadequate for electronic-commerce transactions consummated by either a computer server or website, or both. Moreover, because there is mounting international political pressure to resolve the issue, the time has come to modify the PE requirement by implementing new rules that are specifically designed to handle the unique characteristics of electronic-commerce transactions. The recent OECD consensus represents a step in the right direction by attempting to provide a workable solution to the tax issues that will most likely arise regarding electronic commerce transactions. Likewise, although the new modifications to the PE rules as well as any future ones will continue to put intense pressure on the tax authorities to enforce and administer

these new rules, these new changes should help protect the tax base from further erosion while maximizing the efficiency gains inherent in all electronic commerce transactions.

But whatever solution is put forth, a balance must be struck between the preservation of the corporate tax base and allowing electronic commerce to reach its full potential unimpeded by unwarranted regulation and restrictions. Furthermore, since technology innovation continues to evolve almost on a daily basis, it appears that the current OECD consensus represents only a temporary solution at best and it is likely that this issue will again need to be revisited in the next few years. Consequently, a better solution would be to strive to develop a comprehensive and uniform set of tax rules that applies to all nations engaged in electronic commerce transactions. This would ensure fairness to both developed and undeveloped nations alike while also preserving tax neutrality. In conclusion, this is the real challenge heading into the new-millennium.